

## 7.2 Games Industry Roles and Economics

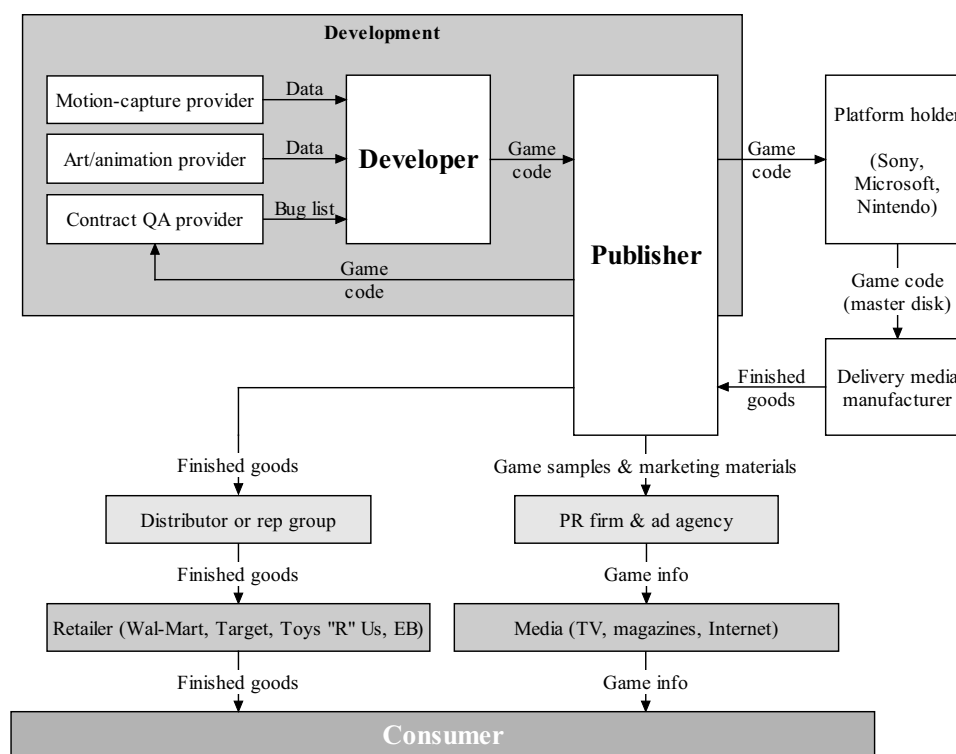
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### Overview

Delivering a game into a consumer's hands is an increasingly complex, lengthy, and costly process. Games industry veterans constantly debate the relative importance of developers as creative auteurs versus publishers as soulless businesspeople, or retailers as channel arbiters versus media as opinion-mongers. However, each “driver” entity on the highway to the consumer—developer, publisher, platform owner, retailer—is essential to the transaction, as the industry's economic structure demonstrates. “Adjunct” entities that feed into the channel also offer a plethora of service alternatives that reduce cost, save time, or improve quality.

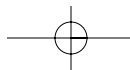
In this chapter, we examine the economics and roles of 11 entities that collaborate to bring a game to market (Figure 7.2.1).



**FIGURE 7.2.1** *Position of each entity in the product path for a console game.*

## Game Developers

Without game developers, entertainment would no doubt be a duller and more complacent activity. Whether independent companies of 15 to 200 people or subsidiaries of larger publishers, developers create the immersive experiences that inspire millions to forego reality for fantasy. Game development involves the very technical disciplines of programming, including code optimization for target hardware, physics and artificial intelligence simulations, camera and interface development, and creation of tools to improve development efficiency. The art of game development lies with designers who envision everything from game balance to placement of doors in a level, artists who realize previously unimagined characters and worlds with an eye toward technical efficiency, and animators who marry a character's appearance and personality through motion. Producers keep the train on the track, identifying roadblocks before (or as) they occur and negotiating solutions among all stakeholders.



### Full-Service Game Developers

Game developers in this category incorporate all the disciplines necessary to create millions of lines of game code from a single idea. Projects range from six-month, tightly focused opportunistic releases to three years of complex asset integration into a whole that is vast in scope. More than one recent project has exceeded five years and \$50 million to complete. The current cost for a multi-SKU console release (PS2, Xbox) now ranges from \$3 to \$8 million, with team sizes of 20 to 50 people. However, major publishers already project development costs of \$25 million or more on next-generation marquee titles, and team sizes for such titles can reach a staggering 350 people.

Given such financials, the proverbial brainstorm-turned-million-seller is rarer than industry aspirants care to believe. The majority of best-sellers are based on existing intellectual property owned or controlled by the publisher, initiated by the publisher with a team whose qualifications (not the least of which is cost) complement that IP.

Publishers can initiate “surefire” projects based on a blockbuster movie or book license, or “questionable” pet projects of a particular executive. Larger publishers can mine the seam of past releases for remakes, due to the hotly debated publisher practice of acquiring intellectual property rights to a promising developer’s original game idea. Two truisms unite all these methods: a “no-brainer” concept does not guarantee a great game, and an offbeat idea, well executed, sometimes sells spectacularly.

Developers interact primarily with their publisher and, on occasion, with the platform provider, who provides them with direct technical assistance for the target platform. Developers also promote themselves and their titles to the media, frequently in conjunction with their publisher.

Independent development companies work with publishers on a contract basis. The publisher pays the developer upon completion of various development milestones. These are technically advance payments against a negotiated royalty based on unit sales; however, the royalty is only paid after the publisher’s advance payments have been recouped. In one recent example, a publisher and developer negotiated \$4/unit royalty, but recoupment against significant development advances ensured the developer would only receive royalties after the 900,000th unit sold. Scenarios like this feed ongoing industry debates about more equitable revenue sharing for developers. Many developers have quietly resorted to building their profit margin into their milestone payment schedule.

Another tightly negotiated contractual term is “net receipts.” Simply, this is the amount of money a publisher actually receives from the sale of the game; net receipts are the basis upon which royalty is calculated. In practice, it can be extremely difficult for developers to figure out exactly how much royalty is due, since each publisher deducts different items from gross receipts to arrive at net receipts. For example, a “generous” (for the developer) definition of net receipts could be limited to actual costs, could be capped at a particular percentage, and could cover only cost of sales,

cost of goods, and a reserve for retail markdowns. However, publishers have been known to claim marketing and overhead charges as well—and to deduct all items as fixed percentages, without the necessity of proving actual outlays. Wise developers always work with legal counsel on such negotiations.

Development groups also exist as wholly or partially owned subsidiaries of publishers. As employees of either the parent company or the subsidiary, internal team members draw corporate salary and benefits. Stock options, bonuses for achieving sales targets, and profit-sharing programs vary widely by publisher; the development community generally acknowledges that the relative stability of working for a major publisher goes hand in hand with a smaller piece of the profit pie on momentous successes.

Other funding alternatives such as venture capital, completion bond funding, and angel financing play a small but growing part in game development.

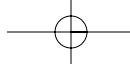
Historically, many development groups have gotten their technological start creating PC games. Wide availability of technical information and a small but active engineering community supported many of today's marquee developers as they created early hits such as *Doom*. Today, developers such as Bioware, id Software, Valve, and 3D Realms include user-creation modules in their games, with which their player communities can modify parts of their games. Many entry-level designers or programmers in the industry today earned their position through a compelling "mod" presented as part of their portfolio.

Development for today's consoles—Sony's PlayStation 2 computer entertainment system, the Nintendo GameCube, and the Xbox video game system from Microsoft—is harder to break into. The expense of proprietary development kits—up to \$10,000—and the requirement of a preexisting relationship with a publisher closes the door to all but the most organized and connected startup groups with previous platform experience. Consequently, many developers earn their credentials in PC gaming, and then make the leap to console on the strength of proven technology, design, and relationships.

### Motion-Capture Service Providers

As hardware platforms follow Moore's law of increasing computing power, consumers and publishers have demanded increasing realism in their games. In particular, developers can now replicate the uniquely identifiable characteristics of human motion with great accuracy for the first time in gaming. Mechanical leg movements on a football player gliding as if on ice have been replaced by true running steps with the inherent force, momentum, and style of the original human player. To be sure, we cannot ignore the stunning contributions of painstaking manual animation to this advancement. However, for the speed and efficiency of achieving realism in human movement, we have motion-capture technology to thank.

Motion capture is the technological process by which scripted movements of human actors are "captured" by magnetic or optical sensors, yielding data that is then inserted into the game engine. *Mocap* is usually used when lifelike human movement



is essential to the game concept. For example, a perfectly replicated signature move in a football video game is a selling point to consumers playing as their favorite wide receiver, while a cartoon character might benefit from manual exaggeration of certain animations to emphasize its unreality. A mocap session is similar to a movie shoot, usually involving a director, a script or “moves list,” an engineer manipulating the software that processes captured data, and actor(s) selected for their ability to repeat the desired action sequence accurately. Once the session is complete, the animation team works through the raw data, tweaking an elbow position or sword arc until the model behaves exactly as desired in-game.

Developers access motion-capture facilities in two ways: the publisher makes its onsite studio available, with costs allocated internally to the project, or directly sub-contracts an external mocap service provider. As with any marriage of the subjective with technology, mocap works best with trained specialists at every level. Publishers with key franchises requiring mocap (such as football games) can recoup on the investment and training for an in-house studio; for most others, mocap is contracted out at costs exceeding \$150,000 for a full-service session.

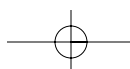
As demand has increased for motion-capture services, the competition among independent mocap studios has led to price pressure. Some leading providers have honed their service-side offering as a result, providing shoot management and data processing, animation tuning, assistance with engine integration, and post-shoot troubleshooting. One provider has productized their data processing software, offering it for license independently of its services. All providers continue to refine the accessibility of data throughout their processes, so developers can benefit from the efficiency of mocap without sacrificing the artistry of keyframe animation.

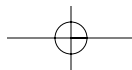
### Art and Animation Service Providers

The increase in computer processing capability in game hardware has provoked an exponential increase in the quantity of art assets required. Onscreen processing limits of several characters comprising a few hundred textured polygons have exploded to millions of polygons making up a main character, several AI characters, a 3D deformable environment with actionable objects, extensive special effects, and realistic environmental lighting. The resulting productivity demands sometimes require outsourcing of the art production process.

Generally, the publisher and developer agree upon the outsourcing of art at contract. A full-service developer might bring an art group to the table based on a previous working relationship, or a publisher might specify a group on its vendor list. In either case, the cost of outsourcing is factored into the project cost and paid during the advance period. Developers generally list contracted art as a separate line item in their proposal.

Art production is one way for fledgling developers to build their reputation on a console platform, particularly if the group's members have a PC background. The developer not only gains access to the proprietary development systems, but also





learns the constraints of art production for the target platform and game engine—from simpler matters such as per-character polygon count to the bedeviling issue of limited texture memory. Art production teams who master these issues build impeccable working relationships with their partner publishers, and carefully hire top-flight programmers that have the best chance at breaking through to full-service independent development.

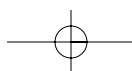
The cost of art production varies wildly with desired quality level, quantity of assets requested, duration of project, and extent of process/logistical integration with the full-service development team. In addition, art production houses run the gamut from long-established, full-time art houses charging top dollar for experience, to startup groups and offshore companies looking to break in at any price. Billing can be per man-month, per minute of cut-scene animation, or flat-fee, and can include royalties if the artwork is integral to the project's brand identity. For the pressured development team who receives a perfectly executed art asset delivery in time to hit a key milestone, and for the publisher whose high expectations for graphic quality were met in that milestone, every dollar is worth it.

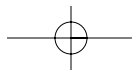
## Publishers

If developers are the artistic brain behind video games, publishers are the muscle and nerve that coordinate all aspects of bringing a game to a consumer. The publisher's role is so extensive and influential that publishers have taken on the aura of medieval fiefdoms, where money flows in mysterious directions and decisions are made by cabal. Acting as the "suits" to developer "geeks," publishers make up the second half of the classic "art versus commerce" conflict that inspires hyperbolic excesses on games industry message boards. If we step back from the rhetoric, we see wide variation within the category: global conglomerates with multiple regional divisions covering internal and external development, marketing and sales, quality assurance, finance and licensing for any viable delivery platform; smaller companies specializing in marketing and sales of certain genres for certain territories; groups specializing in specific platforms such as PC or mobile phones; entities focusing on discovering gems in one territory for distribution in another; and Web sites offering pay-per-play downloads. To choose the best partner, developers must extensively research prospective publishers' strategic priorities, business model, and execution strengths and weaknesses—much of which can be inferred from publicly available information. Mismatched expectations on any of these fronts can doom the best-executed game to the bargain bin.

### Console and PC Publishers

For brevity, and because the vast majority of packaged games wind up in consumers' hands through this model, we will focus on "traditional" console/PC publishers such as Electronic Arts, Activision, THQ, Atari, and Sega. We examine the role of publishers who also control a hardware platform (such as Sony or Nintendo) in a later section. Finally, since we reviewed game development previously, for this overview we will set aside that function of a publisher's role.





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Traditional publishers sit in the conceptual center of the video game industry, primarily because they bear the executional and financial burden of every process between code creation and game purchase. Responsibilities and accountabilities include:

**Management of the game development process:** Publishers are involved in everything from time-to-market scheduling to creative input. The foundation of a publisher's relationship with retail partners is a good product shipped on time in the right quantities.

**Debugging, playtesting, and other quality assurance:** Publishers are legally liable for the game's quality to both consumers and the platform holder.

**Securing all necessary licenses:** These include in-game music; creative properties, trademarks, or technologies controlled by other companies; athletic leagues and players; and the right to publish on controlled platforms (consoles). Experienced developers obtain an indemnity from the publisher against any licensing omissions the publisher might make.

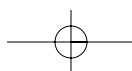
**Manufacturing and shipping the finished game:** This responsibility includes writing and printing the manual, designing the cover, buying the case, placing orders with media manufacturers, assembling all the elements into a game package, and shipping it to the channel. Aside from the QA implications of an unstable assembly process, lackluster packaging encourages consumers to look elsewhere on the store shelf.

**Maintaining good relationships with retailers via cooperative channel inventory management:** More than just the "schmooze" of golf and expensive dinners, publishers' sales efforts must include in-store merchandising programs, funding for product placement in retail circulars ("white space"), joint assessment of a title's sales potential, and markdowns or returns at publisher cost if the title does not perform as expected.

**Communicating title features and availability to the consumer:** Whether via "meta-channels" such as press events for games industry media, or direct communication with gamers via television, print, demo opportunities, Web site, or Internet/direct mail, publishers are responsible for letting the public know what's out there.

**Housekeeping:** This responsibility includes all the human resource, tax and finance, investor relations, and legal services issues involved in running the company.

Industry voices frequently criticize publishers for "unfairly" sharing revenue with their developer, without whose creativity there would be nothing to sell. Since revenue sharing is established at contract, a knowledgeable and firm negotiating stance goes far in ensuring fairness for the developer; the many factors that can strengthen a developer's negotiating position are covered elsewhere in this book. In pure financial terms, however, the market law of risk versus reward explains why publishers keep the lions' share of revenue, if not of profit. Table 7.2.1 answers the gamer's frequent question: "Where does my \$50 go?"



**Table 7.2.1** Generalized Breakdown of Revenue from a \$50 Console Game

Amount	Purpose	Paid By	Paid To
\$3	Cost of goods	Publisher	Media manufacturer
\$7	Publishing license royalty	Publisher	Platform holder
\$13	Retailer profit	Consumer	Retailer
\$3	Markdown reserve	Publisher	Retailer
\$8	Development cost	Publisher	Developer
\$10	<b>Operating cost</b>	Publisher	Internal (overhead, freight, co-op, bad debt)
\$6	<b>Marketing</b>	Publisher	Ad agencies and media

Items in **bold** can be converted to profit through careful publisher cost management.

### Quality Assurance Service Provider

Occasionally, a publisher will decide not to maintain quality assurance (QA) as an internal core competency. Companies such as Absolute Quality or Beta Breakers provide complete debugging and gameplay evaluation to such publishers on a contract basis. The clear advantage is peace of mind about product quality without the necessity of managing the significant human-resource issues and financial overhead of an in-house test team.

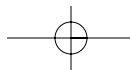
Contracted QA has a long history of success with PC publishers, who bear the unique burden of ensuring that their latest release works within a range of hardware specifications. Depending on the publisher's defined compatibility set, the contract QA house can be asked to test hundreds of variants on PC game software + operating system software + hardware + peripherals, and project results for configurations not tested. Such companies can recoup the significant investment in equipment representing the current gaming market (the "test bed") over multiple projects.

Console publishers are gradually warming up to the idea of contract testing. One obstacle to date has been the expense and proprietary nature of development and debugging systems for controlled platforms. If the publisher provides such equipment to its external QA partner, the platform holder holds the publisher responsible for proper security and authorized use. Another more emotional than factual objection is the perceived risk of code leaks from sources beyond the publisher's own walls; if a game is to be pirated, better to control the leak internally than pursue legal remedies against a partner. During the most recent console transition, contract QA houses made great strides in accommodating these issues, and have since worked closely with both publishers and platform holders to ensure that the figurative firewall includes rather than excludes their services.

### Public-Relations Firms, Advertising Agencies, and Merchandising Teams

Although marketing departments at some publishers look as populated as E3 on opening day, few heads of marketing deny the efficiencies of contracting external





firms for public relations, advertising generation, and in-store merchandising assistance. Much more than additional heads and hands, such companies combine effectiveness through relationships, the creativity that comes from time to brainstorm, and a reach that falls just short of handing a game directly to the consumer.

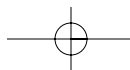
Publishers occasionally learn to their dismay that some brand-name PR firms specializing in national media such as *USA Today* and *Newsweek* can fail miserably at communicating their message to the video games industry media such as *Electronic Gaming Monthly* and *Edge*. The best games industry communications managers successfully pitch the latest role-playing game to a sophisticated news outlet while, on the other phone line, explaining this year's business plan to the local game journalist. The publisher gives the PR firm complete access to its game's development, while the PR firm coaches the publisher on speaking skillfully and consistently to all of its constituencies.

Similarly, a lack of alignment between publisher and ad agency on the creative vision for the marketing plan directly impacts sales. Many top-shelf ad agencies approach the video games industry as a creative soul mate, believing that innovative interactive entertainment requires bleeding-edge advertising. Experienced games industry marketing executives, on the other hand, know that their audience wants to see in-game footage. (Such creative tension results in either a memorable commercial or a new ad agency.) Agency partnerships range from a fully retained relationship covering all software releases, to different agencies retained for distinct product lines, to per-title arrangements.

In-store merchandising assistance is a luxury best afforded by platform holders. With anywhere from 4 to 24 linear feet devoted to its hardware and software in key retailers, for example, Nintendo is legendary for its merchandising team's deep relationships with store managers, enabling them to update signage, straighten displays, restock empty shelf slots, and chat up the electronics section manager on upcoming releases. Publishers whose key releases are integral to a platform holder's lineup can obtain preferential placement and subsequent coddling of their titles by the platform holder's in-store team. Publishers have been known to maintain merchandising teams for shorter or longer periods, but the justification for such cost begins with shelf space; sending staff to straighten up just a few facings is desirable in principle but questionable in financial practice.

### Platform Holders

"Platform holders" are companies that manufacture the hardware (and in some cases, the software) on which game software runs. As with publishers, a wide variety of companies comprise game platform holders: cell phone providers, personal digital assistant (PDA) and other handheld device manufacturers, PC makers (both the boxes and the chips inside them), video game console manufacturers, development software/tools providers such as Microsoft and Silicon Graphics, and Web-based development and delivery services such as WildTangent. Such companies share the characteristic of owning, controlling, or influencing the software that appears on their platform, whether by



providing application programming interfaces (APIs) to help developers access the features of their hardware, or by outright permission-based control of anything that involves the platform. Frequently, platform holders also create software for their own hardware; in this section, we review the platform holder's role exclusive of publishing functions.

Platform holders derive their revenue from any of the following sources:

- Sales of the hardware itself
- Sales of (or licensing fees from) any peripherals compatible with the hardware
- Sales of their own games compatible with the hardware ("first-party games")
- Licensing fees from compatible games made by other companies ("third-party games")
- Licensing of development tools or APIs necessary to create games for the hardware
- Manufacturing proprietary delivery media for the hardware (such as game cartridges)

Consoles and PCs differ fundamentally in that console makers strictly regulate access to their platform via various licensing permissions, while PC makers provide their APIs for free to any interested developer. For this reason, we categorize the PC platform as "open" and consoles as "closed." Handhelds such as PDAs and to a certain extent cell phones follow the "open" PC model, while proprietary handhelds such as Nintendo's Game Boy Advance and DS are just as "closed" as Nintendo's GameCube.

### PCs as a Platform

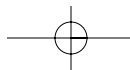
The "PC platform" is in fact a conglomeration of intersecting partnerships among CPU manufacturers, development software/tools providers, graphics chip manufacturers, and box assemblers. Look in the manual for your new PC and you might see:

- Intel Pentium 4 primary processor (CPU)
- ATI Radeon graphics processor
- Microsoft DirectX
- Assembled and sold by Dell

Each of these categories provides support to game developers, mostly for free, with the intent of making money from compatible software or hardware sales.

As the most visible example of successful "ingredient marketing," Intel has spent years courting game developers to maintain its image as provider of the fastest CPUs available. It provides sample boards and technical assistance to game developers, and will even work closely with leading game developers on R&D for its future generations of chips. The objective, of course, is for gamers to specify "Intel Inside" when they purchase their next gaming PC.

Graphics chip companies such as NVIDIA and ATI have built a healthy complementary market to CPUs by creating graphics chips customized for multimedia and, of course, games. In addition to the developer benefits already listed, graphics chip



companies will secure cutting-edge games under development on an exclusive basis, paying the developer to incorporate the technological bells and whistles that set their chip apart from the rest. Graphics chipmakers also create APIs that allow developers to take advantage of their chip's unique features. Once "hardcore" gamers realize that their longed-after new releases look best when run on a particular graphics chip, they gladly upgrade.

Two well-known technology companies have made names for themselves in the development software/tools space. Microsoft, with its DirectX API, has succeeded over the years in stabilizing the technological risk of game development on PCs, much as it has standardized its operating system for the user. Silicon Graphics has created a less widespread, but popular among game developers, API called OpenGL. Both companies give their APIs away to qualified engineers for free, encouraging information sharing among their developer communities and placing as few limits as possible on use. The advantage for developers is learning a software platform that is invisibly compatible with the multiple hardware combinations available in the market.

PC "box-makers" such as Dell and HP play a less active part in promoting game development on their PCs, since the tough work is done by their "ingredient" companies. However, to the extent they target gamers as potential customers, they might secure an exclusive set of games to preload on the PC before it's sold to consumers.

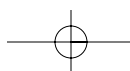
One important factor in PC publishing for developers and publishers is the lack of royalty paid to the hardware company for the privilege of platform compatibility. The beneficial effects are lower cost-of-goods and higher profit margins for publishers, and easier access to both development and self-publishing for developers. However, since nearly any competent and inspired PC development group can complete and ship a PC game at relatively low cost, many groups do so. The resulting competition among thousands of titles for shelf space at retail has created a cutthroat sales channel for PC games, where retailers return units unsold after eight weeks to publishers, and only the top 30 games sell more than 300,000 units.

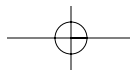
### Consoles as a Platform

In direct contrast to the open and loosely affiliated PC game development scenario, development for game consoles such as Sony's PlayStation 2, Nintendo's GameCube, and Microsoft's Xbox is tightly controlled at all levels by the respective companies. To create and sell games on these platforms, a developer/publisher requires the following licenses and permissions:

**License to use development software and hardware:** Only provided after the console platform holder's favorable evaluation of the applicant's potential for bringing quality games to market. For developers, a publisher's recommendation carries great weight in obtaining development systems.

**License to conduct general marketing and sales activities:** Again, granted only if the platform holder believes the company has the structure and resources to succeed. Smaller publishers without a direct sales force or consistent product





flow struggle to establish credibility on a console platform, sometimes signing its products over to a licensed publisher for distribution.

**License to use the platform holder's trademarks and logos in-game, on packaging, and in advertising:** Platform holders provide templates for all logo and trademark use, and review all materials for correct use before the product can be assembled.

**Permission to create a game:** Granted after platform holder review of the game concept early in the development process. Instances in which platform holders reject a concept, although rare, cause great vexation, as usually the publisher has already sunk funding into the project.

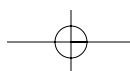
**License to release the game to the channel:** After extensive testing by developer, publisher, and platform holder. Platform holder certification is a tense part of the process, as the game can be rejected any number of times for bug fixes or standards violations.

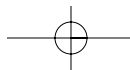
According to industry logic, the company that creates the console, engineers the APIs that developers use to build games for the hardware, and incurs the cost for marketing and selling the hardware to consumers is entitled to royalties from game sales—generally around \$7/unit—to cover those costs. At launch, the retail price of the console rarely covers its actual component cost, and that cost doesn't include R&D amortization. Many millions of units later, after multiple reengineering efforts to reduce the actual bill of materials ("BOM"), successful console platforms can generate vast software-side profits while the platform holder breaks even on the hardware. Over a successful console's lifespan of five to seven years, the platform holder recoups the current console's R&D costs over the first few years, and invests in R&D for the next-generation console during the last few years. An imbalance of software revenues against hardware costs has driven console platform holders such as Atari, 3DO, and Sega out of the hardware business entirely.

### Delivery Media Manufacturers

An often-overlooked cog in the publishing machine is the actual game manufacturing and assembly company. With the exception of Nintendo's Game Boy Advance and DS, today's platforms are disk-based; this welcome change reduced cost of goods for publishers and cut manufacturing time dramatically, enabling (almost) just-in-time inventory management. Manufacturers obtain a license from console platform holders to work with the proprietary disk medium and/or other antipiracy technology on the disk, and pay a nominal per-unit royalty for that technology to the platform holder.

Historically, console platform holders have always controlled manufacturing directly, with Sony and Nintendo continuing this model. Publishers submit their orders directly to the platform holder, or simultaneously to the platform holder and the manufacturer. The publisher pays both manufacturing cost and royalty directly to the platform holder, sometimes on a cash-in-advance basis. During busy seasons when manufacturing capacity is strained, the platform holder has final say over which





products receive priority. However, in general the manufacturer adheres to a certain turnaround time as part of its terms of service. All the same, for an AAA title release date when every day in the schedule counts, even one day over “the standard turnaround time” can cause urgent telephone calls up and down the publishing chain.

With its Dreamcast, Sega was the first to offer complete publisher control of the manufacturing process. Microsoft has continued this trend with its Xbox. In this scenario, once the platform holder releases tested game code to the manufacturer, the publisher is free to negotiate turnaround times and pricing based on the strength of its relationship with the manufacturer. In practice, the cost of goods does not vary widely, but the licensing of three or four manufacturing companies ensures an alternative supplier.

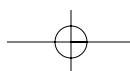
To save additional time or cost, publishers often receive their goods from the licensed manufacturer as unpackaged disks on spindles, and ship them to a separate facility to assemble. Since such “pack-out houses” are not licensed or controlled by the console platform holder, the publisher is free to pursue the most advantageous partnership based on cost, turnaround time, proximity to the publisher’s distribution center, or expertise with different kinds of packaging. Such processes must be managed carefully to prevent Murphy’s Law from afflicting the extra shipping and handling steps.

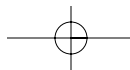
### Retail

As the most visible part of the video game publishing trail to the consumer, retail is rewarded handsomely with as much as a 30 percent margin on a game sale. Many routes a game takes to a consumer’s hands are not visible to the consumer, but certainly influence the game choices with which he’s presented. For the purposes of this discussion, we examine primarily brick-and-mortar stores; online sales of packaged goods have steadily increased but are largely controlled by brick-and-mortar establishments. Long download times and insufficient storage on the client device continue to hamper commercial downloading of games over the Internet, excluding casual games with smaller file sizes. In practice, mass-market online distribution of games awaits greater penetration of broadband connections and a business model that adequately compensates all participating entities.

### Distributors

Although it might seem odd to begin a discussion of retail with the middleman, it’s useful to know that distributors enable smaller regional store chains, individual “mom and pop” stores, and other niche retail outlets to service their customer base uniquely in the face of stiff competition from national discount chains. Distributors buy nearly every game a publisher releases; their strengths are breadth of selection, close cost management, and the ability to sell to stores whose size or business practices preclude dealing directly with the publisher. In short, the distributor brings the publisher incremental sales more efficiently than if the publisher were to service those accounts directly.





Distributors might specialize in differing product lineups. Some distributors located closer to major population centers claim the advantage of quickest delivery of the latest releases. Although publishers frown upon the service, distributors also try to boost their allocation of high-demand titles to supplement national retailers' supply in the critical days between sellout of the first shipment and arrival of the next. Others might focus on "closeouts"—marked-down or discontinued games that make their way from the publisher or retailer's warehouse to the bargain bin at a loss for the publisher but profit for the distributor and retailer. Some distributors focus on making games "rental-ready," repackaging games in sturdy cases for small rental chains. Some distributors act as publishers on import or other low-visibility titles, taking the financial risk on the hope that one might turn out a gem.

In its role of making the market for games more efficient, the distributor itself must be extremely efficient to secure its roughly 3 percent margin on sales. Generally, distributors secure massive warehouse space in low-rent areas, depend on the publisher for sales materials rather than creating their own, and pay their salespeople with heavy emphasis on commission. The cliché of "making it up on volume" is possible for a distributor that works every angle to its benefit.

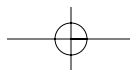
### **Manufacturers' Representatives**

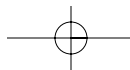
Manufacturer's representatives, or "rep groups," are a testament to the power of relationships in a high-tech world. Usually small companies of just a few people, rep groups secure agreements allowing them to act as contracted salespeople on the publisher's behalf. They're responsible for knowing the product line, the target retailer's operation, publisher practices, and when to sell more versus mark down (although they must recommend the latter to their publisher first). For these services, the publisher pays them a percentage of net sales (all sales minus any returns).

Rep groups are usually of most value in situations where the rep group's relationship and credibility with a retailer is stronger than the publisher's is. This includes launches of new product lines, a new publisher's entry into the market, or reaching out to a retailer not yet included in the publisher's existing retailer base. The rep group acts as go-between, advising both publisher and retailer on how to work through new processes on each side. Despite hard work and sincere commitment by leading rep groups, publisher sales executives constantly reexamine the wisdom of contracting external companies for such a vital task. Perhaps disappointing sales on a key product prompts the initial questioning, or cost watchers eyeing the rep group's commission percentage. The result in either case, and the bane of every rep group, is the publisher's call informing them, "we've decided to go direct."

### **Regional Retailers**

Despite the increasing standardization of the retail experience nationwide, successful regional retailers have learned the keys to survival: know your customer, provide





exactly what he wants, give great service, and offer occasional surprises. These precepts apply perfectly to the game market, where smaller video game-only retailers and mom-and-pop stores can't compete on price or speedy availability of new releases. The smaller retailer can provide detailed knowledge on the latest game or on an obscure release from years back—and if the store manager or buyer is very good, he will know where to lay his hands on both.

The key to regional retailers' success is good relationships with both their distributor and, ideally, with each publisher. Although economies of scale prevent a publisher from servicing regional retailers directly, solid chains with several stores can attract the publisher's notice, either through the grapevine or via distributor's advocacy with the publisher on their behalf for things such as in-store merchandising items and, rarely, markdowns. Since hardcore gamers frequently staff regional chains, publishers can use such chains to create word-of-mouth recommendations from "experts" for their latest releases.

### Rental Retailers

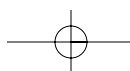
Rental retailers such as Blockbuster and Hollywood Video have emerged from relative obscurity as a retail category to major drivers in the channel. Until recently, publishers treated rental retail with respect but not much attention; although the sell-in quantity "per door" was less than at traditional retailers, those units were never returned or marked down. Recently, however, industry market research from many sources has shown that the primary driver behind consumer purchase intent is hands-on experience with the game. As rentals can encourage sales of a good game, so can they stop a bad game's sales dead at launch. As a result, publishers now work out their lineup carefully with rental retailers, evaluating rental retailers' value in advance promotion side by side with actual units sold.

Rental retailers, in turn, have identified the game market as a potential growth segment of their business. Some chains are experimenting with revenue-sharing models. Other rental retailers are moving into sales as well; having created a potential buyer for a game through rental, such retailers have stopped sending the buyer to a competitor for the purchase. In short, rental retailing is transforming into a new service model for gaming consumers.

### National Retailers

Finally, we come to the names that consumers know: Wal-Mart, Target, Best Buy, Toys "R" Us, and Electronics Boutique. The lineup varies slightly from publisher to publisher, but this group of national retailers makes up the core of the industry's sales efforts, and represents the most direct way for publishers to get a game into a consumer's hands.

National retailers have direct relationships with the publisher, which means that the publisher provides them with:

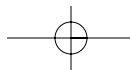


- Games shipped directly to the retailer's warehouse, or direct to store if the retailer can accommodate.
- In-store merchandising materials, such as standees, posters, shelf talkers, and box fronts for display.
- Extensive sales materials on each title, usually including a direct pitch by the publisher's marketing and sales staff to the buyer.
- Generous terms on sales (average net 60, although retailers with clout stretch this as desired).
- Hands-on inventory management, including publisher sales staff poring over store-by-store inventory to increase sales efficiency.
- Various relationship-building perks, such as tickets to a local sports event or an expensive dinner after the sales call. (Wal-Mart is notably strict in its policy of "no freebies" to its buyers.)
- Credits against existing invoices or free goods to help the retailer mark down and move through stagnant inventory.
- Unique sales programs customized by retailers, whether a gift-with-purchase, in-store event or celebrity appearance, or sales contest for in-store staff.

The retail buyer has tremendous influence in the process of getting a game to consumers. The buyer is usually responsible for the entire video game category, but depending on the relative importance of video games to the retailer's revenue, video game buyers might also be responsible for related categories such as video, electronics, or toys. The best buyers listen to the salespeople but also conduct their own research, accepting the publisher's stance but listening to the wants of their own customers. The worst buyers pay little attention to video games, failing to keep abreast of trends or failing to pass information along to store-level employees. Frequently, the difference between a coherent, well-stocked video game department at one retailer and a disorganized jumble of last year's games at a different chain is directly attributable to the buyer.

For publishers, the buyer controls several elements that can mean sales success or failure: whether to stock a game at all, how deeply to stock it, "white space" or co-op advertising in retail circulars, and in-store pricing. The decision to pass on a game can mean forecast deficits of thousands of units if that retailer is responsible for 40 percent of a game's launch volume. Smaller publishers suffer from buyers "cherry picking" their best titles only, while larger publishers and platform holders can benefit from the buyer's courtesy in taking the entire product line. A buyer's decision to stock a game in "gamer-heavy" stores in key locations, but not in minor secondary locations, is a strong sign to a publisher to redouble its in-store efforts to achieve chain-wide distribution. A buyer's decision to show a title in the retailer's "white space" circulars (usually bundled with the daily newspaper) creates a measurable sales spike the week the ad is viewed by millions of avid gamers watching for the next release. Finally, buyers have the authority to designate a key title as a loss-leader, pricing it below the usual \$49 at launch to drive store traffic to higher margin purchases. For hot releases, publishers designate a manufacturer's advertised price ("MAP") program, in which any retailer who reduces their advertised price below a certain level is denied co-op funding for the offending ad.





## 7.2 Games Industry Roles and Economics

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However, this relatively weak penalty is only effective when combined with a strong buyer-salesperson relationship that neither party wishes to damage.

Much as “going direct” are two words rep groups dread, “no open to buy” are four words that bedevil publishers. “Open to buy” is the amount of money the buyer can spend buying games within a certain period, usually quarterly or 30 days. Essentially a budget, it’s calculated from a combination of cost of inventory on hand, sales rate or “turnover” of that inventory, and revenue expected against that inventory for the period. Open to buy is very restricted around the Thanksgiving–Christmas holiday interval, when large numbers of games are expected to sell huge quantities. A publisher salesperson pitching an excellent game who receives the response “no open to buy” is chastised by his or her management for not pitching the buyer earlier on the game’s quality. A salesperson hearing the phrase in response to a poor-quality game should understand this message: Your game isn’t good enough to compete with the other releases during this time period. In short, if the publisher manages its retail relationships well, open-to-buy issues should be no surprise.

To manage such relationships to this degree, publishers require voluminous data quickly and frequently. Publishers can derive sales data of their own games from internal sales information, of course, but sales data on competitive games or titles released during the same period puts an important context around one’s own sales. For example, poor sales of a publisher’s franchise platform title can mean anything; poor sales of the next platformer to appear might mean that that console’s audience doesn’t look for the platform genre; and poor sales of all games during that period might indicate overall industry softness, or poor supply of the hardware platform at retail. For such data, a company called NPD offers a subscription service called TRSTS (Toy Retail Sales Tracking Service) [NPD]. Major retailers report their weekly sales, which then are aggregated and sent back to subscribing publishers on a monthly or weekly basis.

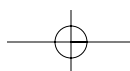
### Summary

The video games industry is now in its third decade of providing interactive entertainment to the consumer market. Through the years, although industry entities have largely retained their roles in the channel, the balance of power (and flow of money) among them has fluctuated widely. All major industry players forecast a skyrocketing of project costs for the 2005–2006 platform generation. Given the amount of money in play, a major stumble by any company in the value chain will not only affect the title in question, but could also turn the entire industry balance of power on its head.



### Exercises

1. Using Microsoft Excel and the data in Table 7.2.1, construct a basic spreadsheet modeling the relationships among cost, unit sales, and profit.
2. Using the cost structure in Table 7.2.1, how many units of this game would you need to sell to break even? To make \$1 million in profit?



3. Using the breakeven sales quantity in the preceding exercise, manipulate the values given you in Table 7.2.1 to reduce your breakeven number.
4. Discuss the advantages and disadvantages of making the following games. Consider budget, project management, marketing, technology, sales forecast, profitability, risk, and quality.
  - a. An NFL football game.
  - b. A game based on an original idea from your company's most famous designer.
  - c. A sequel to last year's game from your company's most famous designer.
5. You are the president of a small development company under contract to a publisher for a game based on your original idea and on your custom-developed technology. You're located in Austin, Texas, and you've been together as a group for five years. The project budget is fairly generous. You realize that you don't have enough artists and animators on staff to achieve your next five art milestones. Do you hire or outsource? Discuss in terms of schedule, technology, budget, company culture, and quality.
6. You are the manager of a video game store in Seattle, Washington. Your store is one of four within a regional retailer selling console and PC games; you order titles for your store through corporate HQ. You know your games and you've been careful to hire staffers who know the industry and pay attention to regular customers' desires. A Best Buy has just opened in the local mall, and last weekend you saw to your shock that they are selling this year's #1 console game at \$10 below your price. What do you do to ensure your shop's continued success? Consider short- and long-term strategies.

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