

European Interactive Games

The 2005 state of the industry
report



screendigest



**European Interactive Games:
The 2005 state of the industry report**

Published March 2005 by
Screen Digest Limited

Authors: Nick Gibson (Games Investor Consulting Ltd) & Ben Keen
Editors: Nick Gibson (Games Investor Consulting Ltd) & Ben Keen
Additional research: Dan Cryan, Kerri Davies, Marc de Gentile-Williams & Nick Parker
Layout: Fintan MacCarthy & Leander Vanderbijl

All rights reserved. No part of this publication may be reproduced, transmitted, or stored in a retrieval system, in any form or by any means without the prior written permission of the publisher, nor be otherwise circulated in any form of cover or binding other than that in which it is published and without a similar condition (including this condition) being imposed on the subsequent publisher.

Copyright © Screen Digest 2005

screendigest

Screen Digest Limited
Lymehouse Studios
30/31 Lyme Street
London NW1 0EE
telephone +44/20 7424 2820
fax +44/20 7424 2838
e-mail editorial@screendigest.com
website www.screendigest.com

Screen Digest is the pre-eminent source of business intelligence, research, and analysis on global audiovisual media. Screen Digest the journal has been published for more than 30 years and is read in over 40 countries. First and foremost, Screen Digest is a research company and publishes a rapidly growing number of major business reports on media markets.

The company also offers continuous online research services providing searchable access to a vast database of global audiovisual market research information. In addition, Screen Digest provides a strategic consultancy service and has undertaken a wide variety of bespoke projects on behalf of numerous national and international organisations.



The Entertainment and Leisure Software Publishers Association

167 Wardour Street
London W1F 8WL
telephone +44/20 7534 0580
fax +44/20 7534 0580
www.elspa.com

ELSPA was founded in 1989 to establish a specific and collective identity for the computer and video games industry. Since then, the membership has steadily grown from 12 to over 100 today, to include all companies concerned with the publishing and distribution of interactive leisure and entertainment software.

ELSPA works to promote the interests of all its members as well as addressing issues that affect the industry as a whole. The strength of ELSPA has been proved to lie in its ability to communicate information of value to its members and provide clear guidance, influence and activity in addressing important issues which affect their business individually or the entire industry.

Printed by Screen Digest

Contents

5	List of tables and charts	24	Consolidation - background
7	Introduction	24	Consolidation - characteristics
	1 Executive summary	26	Consolidation - who benefits and the future
9	The market	26	Specialisation
9	Development	27	Adverse exchange rates movement
10	Development investment	27	The rise of Eastern and Central Europe
11	Employment	28	Outsourcing
11	Exports and balance of trade	29	Middleware and development tools
12	Industry trends	30	Games tools
	2 Industry structure and workings	31	Growing government involvement
13	Development	31	Mergers and acquisitions
13	Publishing	33	Alternative finance
14	Distribution	33	Business models - the search for a new model
14	Retail	33	The standard model
15	Technology platforms	33	Deductions
15	Games industry cycle	35	Royalty rate
17	Investment in the games industry	36	The development business model in practice
17	Public markets	37	Alternative development business models
17	Private equity markets	39	European independent development companies to watch
18	Investment incentives	39	Climax
19	UK investment incentives	39	The Creative Assembly
20	Intellectual property	40	Digital Illusions CE
20	Internal IP	40	Crytek
21	External IP licensing	41	Eurocom
21	License costs	41	Evolution Studios
	3 Developers	41	Free Radical Design
23	Market size	41	Funcom
23	Market composition	41	Lionhead
24	Development trends	42	Rebellion

4 Publishers		6 New distribution channels	
45	Market size and composition	95	Online PC gaming
45	Publishing trends	97	MMOG over-supply
46	Control of risk	97	The resurgence of the casual games market
50	Consolidation	98	Europe key to casual and hard-core market growth
53	Mergers and acquisitions	98	Digital distribution
54	The decaying Japanese market - isolated incident or ill omen?	98	Online console gaming
55	Content trends	99	Diversifying online console business models
56	The connectivity content imperative	100	The battle for online console customer ownership
56	Console software publishing longevity	101	Communications enablement
57	Next generation console prospects	101	Mobile gaming
57	Online piracy	102	The mobile games value chain
58	Publishing business models	104	The mobile games business model
61	Alternative development funding		
62	Other publishing costs		
62	Product promotion		
63	Manufacturing costs		
64	The publishing business model in practice		
64	Publisher pricing		
65	Publisher overheads		
65	Ancillary revenue business models		
68	First-party versus third-party publishing		
76	Publishers to watch		
5 Distribution, retail, peripherals and middleware			
83	The distribution market		
84	Distribution trends		
84	Distribution business models		
85	The retail market		
86	Retail market trends		
88	The retail business model		
89	Peripherals		
89	The peripherals business model		
90	Middleware		
92	Middleware business models		
92	Criterion loses its independence		

List of tables and charts

	1 Executive summary	40	Funcom
9	Europe total: software sales annual value (€m)	40	Lionhead
10	UK: software and hardware sales annual value (£m)	40	Rebellion
10	Number of UK game development studios	43	Reported operating revenues of selected European developers (000 euros)
10	UK game development investment (£m)	44	Reported operating revenues of selected European developers (000 euros) (continued)
11	British cultural industry balance of trade		
11	Employee numbers		
11	2003 british cultural industry exports compared*		
	2 Industry structure and workings		
15	Console hardware cyclicalilty	50	US video games market, publisher market share by value
16	Games company market capitalisation 21 Dec 04	51	UK leisure software publisher market shares
18	Investment in privately held western games companies since 2000	57	EA development expenditure as a percentage of sales
	3 Developers	60	Publishers models
23	Development composition	65	Activision 2003 releases UK launch price retention
24	2002 UK charts' top 15 independent developers (by products' £gross)	65	Electronic Arts 2003 releases UK launch price retention
24	2003 UK charts' top 15 independent developers (by products' £gross)	68	1st party vs 3rd party new releases PlayStation 2 in the UK
35	Developers models	68	3rd party publishers PlayStation 2 in the UK
38	Independent development model	68	1st party vs 3rd party volumes PlayStation 2 in the UK
	SWOT' analysis	69	1st party vs 3rd party ave volumes PlayStation 2 in the UK
40	Climax Group	69	1st party vs 3rd party ave selling prices PlayStation 2 in the UK
40	Creative Assembly	70	1st party vs 3rd party new releases Game Boy Advance in the UK
40	Digital Illusions	70	3rd party publishers Game Boy Advance in the UK
40	Eurocom	70	1st party vs 3rd party volumes Game
40	Evolution Studios		
40	Free Radical Design		
	4 Publishers		

	Boy Advance in the UK	78	SCi
71	1st party vs 3rd party ave volumes	78	Majesco
	Game Boy Advance in the UK	80	Reported operating revenues of selected European publishers (000 euros)
71	1st party vs 3rd party ave selling prices		
	Game Boy Advance in the UK	81	Reported operating revenues of selected European publishers (000 euros) (continued)
72	1st party vs 3rd party new releases		
	Nintendo GameCube in the UK	82	Reported operating revenues of selected global publishers (\$m)
72	3rd party publishers Nintendo GameCube in the UK		
72	1st party vs 3rd party volumes		
	Nintendo GameCube in the UK		
73	1st party vs 3rd party ave volumes		
	Nintendo GameCube in the UK	86	US retailer market share
73	1st party vs 3rd party ave selling prices	86	US retailer market share
	Nintendo GameCube in the UK		
74	1st party vs 3rd party new releases		
	Microsoft Xbox in the UK	95	5 Distribution, retail, peripherals and middleware
74	3rd party publishers Microsoft Xbox in the UK		
	Microsoft Xbox in the UK	96	6 New distribution channels
74	1st party vs 3rd party volumes	101	Western world market: Retail vs non-retail sales
	Microsoft Xbox in the UK	102	MMOG market forecast
75	1st party vs 3rd party ave selling prices	102	Europe: mobile games download revenue
	Microsoft Xbox in the UK	103	Mobile game content M&A transactions
76	Publishing SWOT analysis	103	Mobile game content company funding
77	Electronic Arts	103	Total fundraising by mobile game content companies (\$m)
77	Ubisoft		
77	Midway		

Introduction

This report marks a new chapter in Screen Digest's research relationship with the Entertainment & Leisure Software Publishers Association (ELSPA). Since 1998, we have been working with ELSPA to produce a series of definitive reports on the market for leisure software. This State of the Industry report is designed to be a companion volume to these Interactive Leisure Software: Global Market Assessment & Forecast reports. It is focused on the structure and dynamics of the industry, with a thorough analysis of the changing factors affecting the key players throughout the games value chain.

After a chapter detailing the industry's overall organisation and workings, the report is structured according to the composition of key industry sectors and the relevant players in each - developers, publishers, distributors, retailers, manufacturers of peripherals and middleware providers. Each section describes the business models and terms of trade that operate together with the key trends and market drivers affecting the future of the companies concerned. We close with an overview of the primary new distribution channels—particularly and online and mobile—that are opening up fresh opportunities for the games industry.

up from £186m in 2000. This compares to the UK film industry, which recorded a negative balance of nearly £160m in 2002. The trade deficit in the TV sector was even greater, with imports being £553m more than exports according to the most recent official figures.

Industry trends

The games industry is currently experiencing a time of substantial change that is resulting in the emergence of exciting new opportunities, but also mounting threats:

- The games market is approaching the start of a new industry cycle, precipitated by the launch of the next generation of video games consoles in late 2005 and during 2006. While this will eventually result in new overall market growth, the transition between this console cycle and the next will bring tough investment decisions for publishers choosing which platforms to support. It will also dramatically raise the barriers to entry for developers in terms of the financial and skill resources required to compete in the next generation console market.
- Consolidation within the publisher and developer market continues. As mentioned above, there has been a rapid contraction in the number of UK console games developers in particular, but this has been partly counterbalanced by increased business for the top tier of developers.
- The last five years has seen the evolution of new development, publishing and distribution models and there is little to suggest that these trends will not continue over the next five years.
- Games development continues to diversify beyond the traditional geographic development powerhouses of the UK, USA and Japan. Development territories that have gained substantial ground have included the Nordic region, Canada, Eastern Europe and Central Europe. Local and national government investment incentive schemes, which are becoming increasingly competitive, have contributed significantly to this development migration.
- Games publishing has undergone a rapid maturation process during the current cycle. Increasing average development costs and more competitive retail environments have pushed risk management to the heart of nearly all publisher decision making. Publishing strategies have also increasingly concentrated on the development, ownership, licensing and exploitation of valuable games IP (intellectual property).
- With development cost and complexity maintaining an unceasing ascending trajectory, both developers and publishers are becoming increasingly reliant upon outsourcing, middleware and other third party tools and technologies.
- Network gaming continues to take a rapidly growing proportion of global games revenues and is receiving unprecedented financial backing from venture capital and other private equity funds. Of the approximate \$0.75bn invested in privately-held games companies since the start of the millennium, around 70 per cent has gone to network games ventures (including mobile).
- The online PC games market alone grew to \$1.12bn in 2004. Including online console, iDTV and mobile gaming, total Western (i.e. for US and Europe) network game revenue came to \$1.65bn in 2004. This represented 9.9% of total Western games software sales and we forecast this will rise to 20% by 2008.
- Stock-market listed games companies have raised \$2.4bn so far during the current cycle and the vast majority of this has gone to non-network (i.e. traditional retail-based) games publishers and developers. Despite the amount of money pouring into private network games companies, the traditional games industry value chain and companies within it remain dominant.
- There was a dramatic rise in the volume of Western games developer and IP rights acquisitions in 2004. Around 70 transactions took place, up from less than 20 in 2003 representing around \$0.7bn in total value.

2 Industry structure and workings

Traditionally there have been four distinct stages to bringing a game to the market: **Development, Publishing, Distribution and Retail.**

Development

The design and creation (i.e. coding) of a game. This is done either by a publisher's in-house development resource or a separate third party development company. Most game designs are based on a new concept that the developers have created or a pre-existing template (e.g. a sequel or license) around which they have to create new ideas. The development team is usually responsible for all elements of the game's construction and makes use of people with highly specialised skills ranging from level designers, engine programmers, artists and animators to physics programmers, audio technicians, composers and artificial intelligence programmers.

Funding for a game's development can either come from internal resources or the publishers of the game. Since the funding and sales risk is incurred by others within the value chain, the developer is paid in advance royalties (and if the game's sales are high enough to recoup the advance, the developer receives post-advance royalties). The royalty advance is usually matched to the project's development costs and is usually a proportion of the net wholesale price of the product or net receipts to the publisher. The rate can vary from around 5 per cent to as high as 40 per cent (the industry average is 15-25 per cent).

Publishing

The publishing process involves a number of activities:

- *Games/ developer selection:* Games at all stages of development are pitched to publishers and the publisher must assess not only the sales potential of the game, but also the competence of the developers and the viability of the project overall. For games development projects based around licenses, the publisher must choose the most suitable developer - whether in-house or from a selection of third parties.
- *Funding:* In the vast majority of cases, it is the publisher that funds the development of a game. Increasingly a developer will have had to self-fund the game to a prototype stage before a publisher will commit to publishing it (and fund the remainder of the game's development). Development funding normally takes the form of a royalty advance and is paid on a milestone basis.
- *Producing the game:* Once a game has been signed by a publisher, a project manager or 'producer' is allocated to that title to ensure that the game progresses according to schedule. Should the developers fail to reach a milestone or meet a quality threshold then the publisher normally has the right to cancel the project.
- *Localisation:* The publisher often must also arrange for localisation of the game

for the various global territories in which it intends to publish the product. This has to take account of cultural sensitivities and local legal requirements as well as language diversity.

- *Manufacturing/Distribution/wholesale:* All publishers are responsible for arranging the manufacturing and distribution of a title and some also maintain distribution departments or work with companies that handle the physical distribution of the product. Manufacturing of console games is done under the auspices of, if not directly by, the console manufacturers. Most publishers handle the wholesale of their products to the larger retail accounts themselves, employing third party distributors for the smaller retail chains and independent retailers.
- *Marketing/PR:* Creating hype for a product has become a crucial part of generating a hit and publishers have become increasingly sophisticated in their use of marketing. Marketing budgets can significantly exceed development budgets and tend to be calculated based on the expected revenues from sales of the product over the life of the marketing push.

Aside from the console manufacturers, the largest companies in the games sector are invariably games publishers. The potential upside from the publishing business model is far more attractive than for developers. Although it is higher risk, publishers benefit from retaining the largest proportion of games revenue per unit sold, broader IP (intellectual property) retention and from greater business model scalability.

Distribution

Distribution comprises the physical conveyance and, in many cases, the wholesale of games to the retail chains and independent retailers. Some of the larger publishers have their own distribution infrastructure, often originating from the acquisition of independent distributors. These distribution facilities are often used by other, rival publishers and despite the theoretical conflict of interest, they mostly appear happy with this status quo.

Most publishers, however, use third party distribution companies, even if only to provide the selection, packaging and carriage of their products from the manufacturer/warehouse to individual retail stores or retail chain depots (known as 'pick, pack and ship' distribution).

The larger distributors provide a broader range of services than just pick, pack and ship operations. Most offer wholesale services, undertaking the responsibility for selling publishers' products into retailers and managing these retail accounts. This is particularly common for the many smaller retail accounts whose day-to-day administration would be simply uneconomic for most publishers. Some publishers use multiple distributors to engender competitiveness to maximise their distribution reach; others have adopted an exclusive approach handing all of their distribution requirements to a single company.

In some territories, the line between distribution and publishing can be very blurred. This is particularly the case in continental Europe, where many distributors offer to perform a complete sales and marketing role too and even provide guarantees and advances to the original publishers.

Retail

Retailers, through high street, mail order or website, sell the products on to the consumers. With the help of the publishers and distributors, the high-street retailers co-ordinate point-of-sale marketing through the use of in-shop displays, demos and posters and determine which titles will fill their (usually) very limited shelf space. Retailers are also the first point of call for returns.

Games are being sold in an ever-broadening array of locations, although to some degree this breadth is partly based on the fortunes of the market. Thus, in the transition between one generation of games console and the next, some retailers may opt out of stocking games until a sufficient installed base of new consoles has been reached and software sales for these new platforms have become sufficiently mass-market. Some supermarkets will, for example, only stock chart product for the dominant PlayStation 2 console and little else.

expected to reach in excess of \$2bn by the end of 2008. Hard-core online gaming represented 40 per cent of the 2004 market by value and 25 per cent of total online gaming households.

Below we look at some of the major trends within online PC gaming. A detailed assessment of the online computer games markets can be found in the 2004 Screen Digest report: *Online Gaming Markets to 2007*.

MMOG over-supply

The massively multi-player online games (MMOG) market has frequently defied critics' prognoses of demand plateaus and curtailed growth and expanded dramatically in 2003 and in 2004 following the launch of some major new MMOGs such as *Star Wars Galaxies*, *City of Heroes*, *Everquest 2* and *World of Warcraft*. Not only are total subscribers continuing to rise, but average subscription values are also increasing.

The financial rewards for a successful MMOG are appealing, with annual revenue in the tens of millions and net profit margins (excluding initial development cost amortisation or write-off) as high as 35-40 per cent attainable. This is exacerbated by the remarkable 'shelf' lives of successful MMOGs, some of which are over five years old and still retain a subscriber base of over 200,000.

Over the last three years, this has led to a substantial increase in MMOG investment - both from within the games market - as well as from external financial sources (over \$60m was invested in Western MMOG development companies by private equity companies in 2003 alone).

There are currently 127 MMOGs that have been completed and released within the Western market. We believe that there are a further 70 in development and scheduled for release during the next 3 years.

Unsurprisingly, some major over-supply problems have begun to become apparent.

We believe that the number of new MMOG launches scheduled for the next three years will not be supported by a commensurate rise in overall subscriber numbers. With typical MMOG development costs in excess of £6m, and infrastructure and launch costs at a similar, if not greater level, an MMOG publisher has to commit a vast sum before it can start to generate any revenue. Furthermore there is no guarantee,

however much is invested in the MMOG's development, that the title will gain subscriber traction (as seen with *Earth and Beyond*, which failed to advance beyond around 40,000 subscribers despite substantial initial investment and was closed by publisher Electronic Arts in early 2004).

In addition, the publisher also has to provide onerous ongoing customer support and continual product development. MMOG publishers have begun, therefore, to be faced with difficult choices about whether their MMOG can withstand the mounting competitive pressure and can become economically viable. Many have opted out, resulting in a wave of major MMOG project cancellations in late 2003 and throughout 2004 (*Mythica*, *True Fantasy Live Odyssey*, *Earth and Beyond*, *Citizen Zero*, *Ultima X: Odyssey*). Indeed, 44 MMOGs have now been cancelled in the last 26 months alone, representing a failure rate of one in four.

We expect this supply-side thinning to continue, but an imbalance will remain and is already leading to a re-appraisal of pricing and player incentivisation strategies. MMOG developer Mindark's *Project Entropia* (which has no subscription but charges players for in-game to real world currency conversion) has rapidly become one of the most popular MMOGs whilst Funcom has recently decided to abandon subscription charges for its *Anarchy Online* MMOG until 2006 in order to investigate new business models.

The resurgence of the casual games market

The casual online games market suffered considerably with the deflation of the dotcom bubble. Most casual games websites were wholly reliant upon advertising for their revenue and, with advertising rates dropping to a tenth of their peak level in the late 90s and early 00s, the outlook for the industry appeared bleak. However, users continued to flock to the sites in volume and in 2003 the online advertising market recorded its first year of growth for three years. Casual games sites have been buoyed by this advertising market recovery, but most have long-since diversified their business models to protect against weakening advertising sales. Some of these new models are proving remarkably successful.

Pay-per-play casual gaming is where gamers pay to enter skill-based games tournaments in which cash and merchandise prizes can be won. Tournaments can vary from two-person direct challenges to time-limited tournaments with thousands of participants.

The emergence of this model in the early 2000s led to the formation of dozens of specialist pay-per-play games service providers, many of whom are now matching and in some cases exceeding the revenues of the largest advertising-based services and with a fraction of the user base.

Other successful models are subscription-based access to premium casual games channels such as Electronic Arts' Club Pogo (with over 600,000 paying subscribers) and casual game downloads where gamers pay to download offline-playable versions of their favourite online games.

Interestingly, female gamers now dominate every form of casual online games playing. Women comprise over 60 per cent of all the larger casual games sites and represent the majority of those willing to enter pay-per-play tournaments, subscribe to casual online games services and buy downloadable casual games. Some are even more female-dominated. 75% of Club Pogo's paying subscribers are women. To further accentuate the contrast with the hard-core market, the largest age categories for casual online gamers are 35-44 and 45-54 years old.

Europe key to casual and hard-core market growth

Both the casual and hard-core online games markets are centred around North America. Most companies servicing these markets are based there and most are still targeting North Americans only. European launches are fraught with difficulties - from adherence to local laws and customs, to catering for language and currency diversity.

We believe that neither types of company - hard-core or casual - have tried to tap the European market to any great degree and, in some markets, this has precipitated the formation of indigenous service providers who are relishing their unfettered ability to exploit this market gap. However, the major US online games service providers and MMOG publishers are increasingly concluding that Europe, with its higher

population level, PC homes and Internet users is the key to the maintenance of their long-term growth. This will be reflected in an increasing number of European product and service launches over the next twelve to twenty-four months.

Digital distribution

Long-threatened but, as yet, not a widespread material threat to the boxed product model, the use of digital networks for the distribution of games software received its first high profile test with the launch of Valve Software's *Half-Life 2* on PC in November 2004.

Whilst digital distribution technologies such as application streaming (which sends parts of a game to the player's PC as and when needed, but never the whole game) and encrypted downloads (where games are downloaded in their entirety and only playable once "unlocked" with a verified payment) have existed for many years, most publishers have been reluctant to allow new or premium product to be distributed electronically. An element of distrust is behind their rationale although an unwillingness to disintermediate their distribution, and more importantly, retail partners is also at play.

Valve, a developer, is in a relatively unique position amongst its peers in retaining the electronic distribution rights to a title that, to all intents and purposes, was a guaranteed hit. To take advantage of this, Valve invested in a comprehensive online distribution and management system, Steam, which, before *Half-Life 2* had even been released, has accrued over 1m users. Valve has yet to release official Steam sales figures although they are understood to be sufficient to have made a material dent in retail sales.

Given the margin improvements that Valve realise on an online sale versus a boxed product sale (the Steam price point is the same as the boxed product SRP and Valve has publicly stated it will at least triple its per-unit take on Steam sales over traditional retail sales), it seems Steam's commercial success is already assured. IP and cash-rich developers (albeit very few in number) will doubtless be watching closely, as will publishers who are particularly interested to see whether there actually is a market for digitally distributed premium quality titles. If Valve can attract a