



ELIE OFEK

Home Video Games: Generation Seven

Q: Most in the biz feel that Xbox 2 will launch in 2005. Do the moves of the competition affect when you'll release your next console?

A: We're not concerned with who's coming out first or who's coming out last. And if you look back at history, we were never the first to market. Remember Saturn? Remember Dreamcast? That was supposed to be "the" next-generation online console and we saw what happened there.

—Kaz Hirai

President, Sony Computer Entertainment America¹

By all accounts in early 2005, the current generation of video game consoles, which included Sony's PlayStation2 (PS2), Microsoft's Xbox, and Nintendo's GameCube, had begun its descent in terms of sales as anticipation for the next generation of game consoles began to build. Although U.S. sales in 2004 of the overall videogame industry (consoles, portable devices, and software) decreased only slightly to \$9.9 billion from \$10 billion in 2003, the component of sales for hardware plummeted by 27%.² Moreover, prices for game consoles had declined steadily. For example, the retail price for Sony's PS2 was now \$149, about half its price at launch.³ The proverbial 'good news' in these sales statistics was that demand for videogame software was stronger than ever (up 7% to \$6.2 billion in the U.S. or 248 million units sold). Worldwide sales of video games in 2004 were \$24.5 billion and were projected to soar to \$55 billion by 2008.⁴ The typical game console player was now twenty-four years old, having grown-up with video games as a teenager and now with the disposable income of a full-time job.⁵ Besides increasing the number of older game players, video games were also drawing kids as young as 7 years old away from traditional toys like Barbie and G.I. Joe.

Despite the rosy outlook for the video game industry, for Sony Computer Entertainment and its parent company, Sony, the 'bad news' was beginning to mount. Sales of PS2 in the 2004 holiday season were below expectations. In the U.S., PS2 sales in December 2004 were 990,219 units, down from 1.94 million units a year earlier – a decrease of nearly 50%! While sales of the Sony PS2 and

¹ Bryan Intihar and Mark MacDonald "Let's get ready to rumble: Sony, Microsoft, and Nintendo set up camp and provide intel on their next-gen console battle plans" *Electronic Gaming Monthly*, Feb 1, 2005.

² Matt Ritchel "Video game industry sales reach record pace in 2004" *The New York Times*, Jan 19, 2005.

³ Ginny Parker "Sony unveils smaller version of PlayStation 2 game console" *The Wall Street Journal*, Sep 22, 2004.

⁴ Ronald Grover, Cliff Edwards, and Ian Rowley "Game wars" *Business Week*, Feb 28, 2005.

⁵ Matt Ritchel "Game sales thrive thanks to the big kids (in their 20's)" *The New York Times*, Dec 27, 2004.

Professor Elie Ofek prepared this note as the basis for class discussion.

Nintendo GameCube suffered greatly in December 2004, Microsoft Xbox unit sales only decreased 4% from the previous year (Exhibit 1). More importantly, though Xbox was launched a substantial 20 months following PS2 in the current generation, Microsoft appeared to have the lead in bringing its next generation game console, code-named Xenon, to market. Expectations were for a release of Xenon in time for the 2005 holiday season, well ahead of Sony and Nintendo, which weren't expected to launch their next generation consoles until the spring of 2006 at the earliest. "We may still be losing money, but I bet we can take Sony next generation," said Microsoft CEO Steve Ballmer.⁶

As this generation of game consoles edged closer towards retirement, Sony was still the undisputed market leader with worldwide PS2 cumulative sales of 80 million units and a share of 56.4% in the U.S. market, the largest console market in the world. Yet, as evidenced over the course of the first six generations of video game consoles (Exhibit 2), market leaders were not invincible and could certainly be displaced by a worthy competitor. In 2004, Microsoft's Xbox surpassed Nintendo's GameCube as the No. 2 console in the U.S. market (24.9% vs. 18.7%). By beating Sony to market in the upcoming seventh generation of game consoles, would Microsoft's next generation console gain an insurmountable lead over the PlayStation3? The stakes were high, especially for Sony.

The Fall of Sony?

Throughout its history, Sony has been widely considered as one of the most innovative companies in consumer electronics with iconic successes such as the Trinitron TV and the Walkman. But to industry observers, in recent years that image has been replaced with that of a company attempting to reinvent its core electronics business while also trying to achieve the synergy between hardware and digital content that was envisioned when it acquired music labels and movie production companies in the late 1980s. In early 2005, Sony appeared to be struggling on both fronts.

First, the commoditization of semiconductor components that comprised the guts of many of Sony's electronics products (e.g., TVs, DVD players) was eating away at profits since smaller rivals from Korea, China, and Taiwan could quickly develop and bring to market cheaper alternatives to Sony's products. And although Sony's electronics division contributed 62% of revenues in the last fiscal year, it lost money in terms of net income.⁷

Second, although Sony management continued to express its commitment to achieving synergies between its electronics division and its music and movie content businesses – now a 15-year work-in-progress – the naysayers were becoming more vocal. According to industry analyst John Yang of Standard and Poor's, "they have really steered away from their core competency, which is to make good electronics products. They've purchased the film business; they've tried to make money in games, music, what have you. But now it looks like it's taking its toll".⁸

The most compelling evidence of Sony's unrealized vision to successfully combine its electronics hardware expertise and ownership of content has been its inability to capitalize on the rapidly growing market for digital music players. For the company that introduced the Walkman, the rise of Apple's iPod and iTunes music download service has been particularly frustrating. Ironically, because of piracy fears, the fact that Sony owned so much music content appeared to hinder its ability to develop an innovative digital music player and music download service – quite the

⁶ Holman W. Jenkins Jr. "Just how crazy is Xbox?" *The Wall Street Journal*, Sep 22, 2004.

⁷ Todd Zaun "Sony says year's sales and profit will miss targets" *The New York Times*, Jan 21, 2005.

⁸ Jake Lloyd-Smith "How the sun went down for Sony" *The Evening Standard* (London), Jan 28, 2005.

opposite of the synergy between hardware and content that was expected. Neither Sony's digital music player nor Sony Connect, its online music service, had been very successful in the marketplace.

On January 20, 2005, Sony projected a 30% profit decrease from their previous forecast. However, the most shocking announcement was made on March 7, 2005, when Sony's chairman and chief executive, Nobuyuki Idei, resigned and handed leadership of the company to Howard Stringer, a Welsh-born American who was currently leading Sony's operations in the United States. *The Wall Street Journal* called the change "the biggest management upheaval in Sony Corp.'s 59-year history".⁹ Furthermore, it was not clear whether Ken Kutaragi, head of Sony Computer Entertainment and who many saw as the likely successor to Idei, would elect to stay with Sony. Often called the "Father of PlayStation", Kutaragi's loss could affect the development and launch of the next PlayStation.

Video Games in 2005: Convergence and the PlayStation Portable

The rise of video games as the entertainment outlet of choice had negative implications for TV and movies in the form of stagnated or declining audiences, especially in the critical demographic of 18-to-34-year-olds. Consequently, in 2005, film studios and media companies were looking to get into the game (literally) through a slew of partnerships with game development companies. For example, Paramount Pictures joined with Electronic Arts (EA) to develop a game in which the characters mimic the strategies of the Corleones, the mob family from the epic movie *The Godfather*. In addition, video games based on movies like *The Incredibles* were being used "to keep a story in consumers' minds" until a movie sequel could be developed.¹⁰

The movement of content from the silver screen to the video game screen, however, was by no means a one-way street. In early 2005, Microsoft announced that it planned to produce a movie version of its *Halo* video game franchise, a blockbuster hit in the game industry that had grossed \$600 million since 2001. Sony's *Spider-Man 2* video game, based on the company's successful movie release, was among the top 10 in 2004, selling more than 1.1 million units in the U.S. at an average retail price of \$43.¹¹ This was perhaps the only positive sign of synergy between Sony's content and electronics businesses.

At the start of 2005, Sony Computer Entertainment was also hoping to capitalize on another form of convergence with the introduction of the PlayStation Portable (PSP). The portable device measured 6.7 inches long and 2.9 inches wide – too large for a typical pocket – but was less than one inch thick and weighed just 9 ounces or about 250 grams. Though a fraction of the size of a console, PSP was comparable to the PlayStation2 in terms of graphics quality and processor speed, and it featured wireless (Wi-Fi) connectivity for multi-player game competition via the Internet. These characteristics made it a direct competitor to Nintendo DS, Nintendo's successor to its own well-entrenched market leader, Game Boy. Unlike Nintendo DS, which was designed specifically for video games, Sony designed PSP to also play movies and music and to display digital photos. With these additional features, Sony aimed to attract older video game consumers as well as the potential owners of iPods or portable DVD players. But these additional features also came at a price; in the U.S., PSP retailed for \$249 while Nintendo DS was only \$149.

⁹ Phred Dvorak and Merissa Marr "Sony, lagging behind rivals, hands reins to a foreigner" *The Wall Street Journal*, Mar 7, 2005.

¹⁰ Ronald Grover, Cliff Edwards, and Ian Rowley "Game wars" *Business Week*, Feb 28, 2005.

¹¹ Press release "The NPD Group reports annual 2004 US video game industry retail sales" *The NPD Group*, Jan 18, 2005.

The early reviews from PSP's U.S. launch on March 24, 2005 were mixed. On one hand, reviews on the PSP as a handheld videogame device were quite positive. Notably, Walter Mossberg of *The Wall Street Journal* called the PSP "an impressive handheld game player with great graphics, good game controls and strong multiplayer capabilities".¹² On the other hand, reviews of the multimedia capabilities of the PSP were more critical, as illustrated by Stephen Wildstrom's review in *Business Week*: "The frustrating part is that the PSP can play movies only from a sort of mini-DVD disk in a proprietary design that Sony calls a Universal Media Disc (UMD). Only a handful of titles, mostly action films such as Sony Pictures' Spider-Man 2, are available initially — at \$20 a pop — and it's far from clear whether studios will embrace the format. Sony has no plans to offer recordable UMDs, and since the PSP has no hard drive, you're stuck with what is available prerecorded".¹³ The use of UMDs also meant that PlayStation2 games could not be played on the PSP and that new versions had to be specially developed and marketed for the PSP platform.

Next Generation Consoles: Differences in Strategy and the Battle Ahead

...somehow, some way consumers in the future will probably need a device to organize all the digital fun streaming around their lives. Sony believes the superbox will sneak into the living room in the guise of a non-threatening consumer appliance...For the next iteration of its star game [PlayStation] platform, Sony is spending \$1.67 billion to develop a "cell" chip capable of teraflop speeds. In one swoop, Sony will place a supercomputer in an innocent-looking piece of entertainment hardware and drop it into the home, leading couch potatoes painlessly to their digital nirvana.

—Holman Jenkins, *The Wall Street Journal*¹⁴

The differences in next-generation strategy between Microsoft and Sony were reflective of the historic expertise of each company. Microsoft's strategy was to focus on the game development process through the creation of XNA, a new set of software tools that could be used to write games for the PC, Xbox, and the next generation Xbox. The strategy behind these tools was to provide a faster and less expensive way for game creators to build games for the Xbox franchise. With development costs for a single game as high as \$20 million, up from about \$3 million five years ago, the tools were expected to attract game development talent to the Xbox platform.¹⁵

Sony, for its part, was focusing on the development of a revolutionary hardware platform called the Cell with partners IBM and Toshiba. The Cell chip was designed to act as a system of processors — one primary Cell chip can either perform particular operations or delegate them to another Cell chip. By distributing the processing efforts so efficiently, several Cell chips put together have been capable of running at 256 gigaflops, or about 10 times the speed of the fastest PCs today. Although the Cell had been praised for its ability to process previously unattainable speeds of streaming video and sound, its use in the next generation PlayStation would not be without potential risks. Most notably, the development of the Cell was expensive and time-consuming. Until now, only Microsoft had committed to delivering its next generation console in time for the 2005 holiday season. Furthermore taking advantage of the Cell's immense processing speed required a major change in the way video game software was written, potentially adding to the 18-month lead time necessary for

¹² Walter Mossberg "The PlayStation goes portable" *The Wall Street Journal*, Mar 16, 2005.

¹³ Stephen H. Wildstrom "PlayStation Portable Has Miles to Go" *BusinessWeek*, Mar 24, 2005.

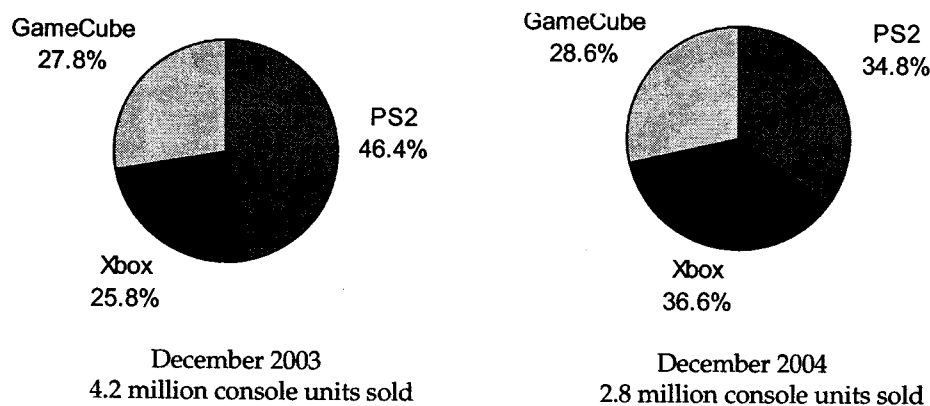
¹⁴ Holman W. Jenkins, Jr. "Just how crazy is Xbox?" *The Wall Street Journal*, Sep 22, 2005.

¹⁵ Ronald Grover, Cliff Edwards, and Ian Rowley, Feb 28, 2005.

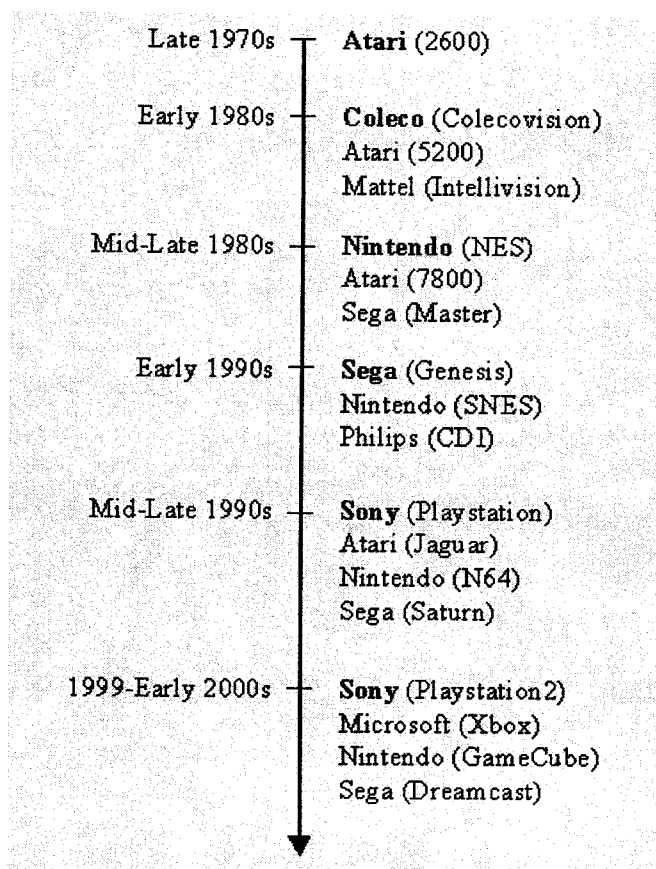
game developers to create video games for a new console platform. The effect that this would have on the delivery date of the next PlayStation remained to be seen.

As the battle for the seventh generation of home video game consoles started to unfold, it was unclear as to which factors would ultimately lead to the success or failure of each company. For instance, was it really important to be first to market with the next generation console? Was software or hardware more important in this market? In the case of hardware, by developing the Cell would Sony be successful at creating a "superbox" for the living room (i.e., convergence in hardware)? In the case of software, was the observed convergence in content between movies and video games an advantage to a company like Sony, which had both? And in light of the challenges that it faced, would the Sony brand name help or hinder it as the next generation of consoles unfolded?

The answers to these questions will certainly affect how each company positions its new game console in the coming months. Now the battle really begins ...

Exhibit 1 U.S. Market Share of Consoles: December 2003 vs. December 2004

Source: Adapted from NPD Funworld

Exhibit 2 Timeline of Previous Generations of Video Game Consoles (market leaders in **bold**)

Source: Compiled by the author