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A NEW BUSINESS MODEL APPEARS!

How Leveraging Business Models Levelled-Up the Video Games Industry

Paper Type: Investigation

Abstract

This paper investigates the role of business models in the commercial and critical success of video games within the industry. Using academic literature to define and highlight the importance of business models the paper goes on to explore how innovative and disruptive business models can make a difference in the ability of companies to claim success with the titles they produce. The reoccurring importance of business model innovation is highlighted and a brief exploration of the relevance and perception of the different business models at play is presented.

This is followed by an in-depth investigation of several examples in a critical manner, with each example being buttressed with insights from academic research to explain some of the problems companies face incorporating business model innovation. A positive story of one developers struggle to find its place against an overwhelming tide of change sheds light on how some companies may be able to survive in a digital market that is in a state of constant advancement and change. Finally, a look at when consumers push back at what they consider are exploitative business practices stemming from these innovative business models.

In conclusion it is found that overall the industry seems to adapt and flourish thanks to its kindred relationship with the technology that makes business model innovation possible.

Introduction

For the first forty years the video game industry sold boxed retail media products, mimicking the film and music industry. However, it was with the rise of the internet that video games began to break away and eventually usurped these relatively ancient colossi and became the goliath of the entertainment industry that we see today.

This paper explores how the video games industry rose to such heights, predicated on the speed at which they can respond to market change, a result of its constituent companies' ability to adopt innovative and at times disruptive, new business models.

This paper is not an exploration of the revenue models in detail, but instead focusses on how business models – that is, the business process and revenue model, as well as the interplay between them – can affect the commercial and critical success of a product, a company and the wider video game industry. For this reason, there will not be a discussion on the economic and financial implications of business models, but instead a critical discussion on the current professional, legal, social and ethical issues surrounding the professional practice of games design in the wider context of the games development community and of society.

Investigation

Business Models

A Definition

While *business model* is a multivalent term Baden-Fuller & Morgan (2010) describe it as a well-known recipe, one that concisely captures the essence of a business's characteristics and activities. Much like a recipe, the success of employing it depends upon the prowess of the chef(s) (i.e. management) whom follow them.

It is important to make the distinction between the business model, revenue model and strategy, as the three are often thought of together or the meanings are used interchangeably. A revenue model is a profit-yielding revenue structure (Magretta, 2002). Where the business model describes how the systems –business processes and revenue models – fit together, strategy explains how to deal with competitors.

Do They Matter?

Malone et al. (2006) studied the business models of all 10,970 publicly traded firms in the US economy from 1998-2002 and concluded that no model could be seen to give a clear advantage, but that some produce better financial performance than others. However, back then e-commerce was fledgling compared to today's dynamic digital markets.

Krumeich et al. (2012) highlight that rapidly progressing ICT infrastructure has created new economic and social situations that afford small start-ups competitive advantages, allowing unique value propositions through the creation of products and services that exploit innovative and disruptive business models and technologies. Gambardella & McGahan (2010) argue that modern industry-changing or market-leading companies are those that use business model innovation to shape not only their business structure but also their customer interactions in novel ways.

Video Games Industry

"Son, you're special..."

Models used in the video games industry have been innovative or outright disruptive and have contributed to widespread change. Reducing barriers of entry to technology and the internet enable companies a wider range of choices in how they create value through their business models (Locke & Uhrínová, 2017). Combined with the fundamentally technological nature of video games this has immediate implications for game companies. It acts as a strong market driver that propels the industry forward at a rate unmatched by other entertainment mediums.

A new business model alone can be so economically disruptive that it creates a huge competitive advantage for a company. However, maintained success depends upon not only how long you can execute your model but also how you deal with the inevitable competition from imitators (Magretta, 2002).

"...to be a source of competitive advantage, a business model must be something more than just a good logical way of doing business. A model must be honed to meet customer needs. It must also be non-imitable in certain respects, either by being hard to replicate, or by being unpalatable for competitors to replicate as it would disturb existing relationships with customers or suppliers."

- (Teece, 2010)

Chesbrough (2010) asserts that companies must be able to innovate their business models, as bringing a product or service to market using two different models can produce greatly differing economic outcomes.

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Massa & Tucci (2013) suggest that designing a business model for a startup or reconfiguring an existing model can both lead to business model innovation, if characterised by some degree of novelty or uniqueness. To innovate, organisations need to reconsider the fundamental business processes that make up their business model.

Perception of Different Revenue Models

Olsson & Sidenblom (2010) presented six classifications: *retail; digital distribution; subscription; player-to-player trading; micro-transactions*. They then conducted a survey which found that consumer perception and attitudes towards advertising, player-to-player trading and microtransactions were generally unfavourable. Consumers more favoured traditional retail distribution or digital distribution, as they were more familiar with both and each was seen to have either the benefit of being clearly priced or convenient. Favour towards subscription fell in the middle of these extremes, with the consensus among respondents being that subscriptions are considered more expensive overall.

One popular new addition to these models, *micro-transactions*, covers a large swathe of implementations, with the most recognisable being called *Free-to-Play*.

Free-to-Play (F2P)

A business model can fundamentally change how games are designed and consumed. Arguably the most innovative and disruptive business models currently stem from the F2P revenue model. Finding life first on the mobile platform, due to a race to the bottom in pricing, F2P quickly found its way onto the PC platform and continued to expand in popularity, filtering out into the console games market.

“You don’t always need a new business model to capitalize on a game changing opportunity. Sometimes... a company finds that a current model is revolutionary in a new market.”

- (Johnson, et al., 2008)

Davidovici-Nora (2013) attributes the shift from physical to digital platforms as pivotal. The industry swiftly embraced F2P and that it changes the relationship between developer and consumer, because it reverses the logic of the value chain, turning video games from a commodity into a service. However, the success of F2P game titles requires different business processes, as the gameplay design and monetisation economics are so dynamic and subtly intertwined he argues. Successful F2P requires metrics that measure player engagement, with that data then being fed back into the games core design and revenue model.

Wirtz et al. (2010) agree that it is important for managers understand the kinds of value that can be created in any given market context. Considering the state of an industry can be in constant flux, they need to be able to address change by adjusting their business model to best meet the climate of the market environment and to maintain or acquire competitive advantages.

Failure to Adapt

Teece (2010) maintains that it can be hard for organisations to innovate or reconfigure their business models, as management often doesn’t understand their existing ones well enough. However, by doing so companies can drive spectacular growth or reshape whole industries by capturing opportunities to provide value. Chesbrough (2010) adds that business model innovation is often very difficult to achieve as conflict, understanding and organisational change are barriers need to be overcome through experimentation, effectuation and successful leadership. Therefore, despite the benefits of being able to adapt to market needs it is often the case that companies are slow followers, rather than being proactive innovators.

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In his analysis of *LawBreakers* (Boss Key Productions, 2017), nerdSlayer (2018) argues that the title suffered failure, in part, due to the developer being opposed to using a F2P business model, despite this their original plan and being backed by a publisher who releases successful FPS games under that model. He points to veteran developer and business owner Cliff Bleszinski being uncomfortable with the F2P model, being unable to reconcile it with his vision for the game. nerdSlayer argues that going against market trends in the face of strong competition may have been the most significant contributing factor in the games failure to become a sustainable long-term investment for the company, its publisher and its fans, despite generally positive critical reception of the game.

These struggles mentioned by Teece and Chesbrough can be seen with other companies in the industry. Some are companies more forward thinking, some simply ignore trends and hold their ground and yet others chase trends and implement popular revenue models with naivety to the implications on the business model, game and customers.

Trading Sustainability for Profit

MMORPG *ArcheAge* (XL Games, 2014) failed to maintain its player base when the games F2P model shifted to what is considered a Pay-to-Win (P2W) revenue model, which generated a lot of negative sentiment among fans. Trion, the licensee publisher for the game in the West, was perceived to have lied to fans in the wake of the change. The problem for some was that by giving players, who were willing and able to spend money, the ability to purchase advantages in the game, *Trion* as the publisher of these games was actively affecting crucial in-game economies in game breaking ways for players who were not inclined to or were less able to spend. nerdSlayer (2017) cites this case and argues other publishers are also short-sighted in this way but continue to see P2W as a preferable business model with which to generate maximum revenue.

Itami & Nishino (2010) argue that a good business model needs to not only satisfy your customers' needs better than the competition, but it also needs to function as a system for people within the organisation to learn more about its customers, technology and markets. They go on to warn managers that this means they need to seek both short-term profit opportunities, as well as learning potential for the long term. The knowledge that comes as a by-product of this system will allow a business to rapidly gain insight in a market and represents a considerable competitive advantage that is vital to its overall long-term success.

While some publishers may be brazening to clutch at the profit potential a revenue model can generate, other segments of the games industry are wary to follow so fast. In a panel from *VRX 2017* (VR Intelligence, 2018), Denny Unger warns that games companies in the nascent VR industry can't afford a race to the bottom to try and attract more users to purchase their content. He urges companies to experiment with business models that are sustainable while the market expands beyond early adopters.

Developers Act

Antonaides (2014) makes a case for developers to rethink their historic relationship with publishers. He espouses belief that small, persistent teams of talented developers can craft high quality, more narrowly focused games at a fairer price, without the excessive baggage and budget of AAA production.

His company, *Ninja Theory*, wanted to subvert the pervading attitude that there is no longer a space in the industry for revenue models that can bridge the gap in development budget between AAA and indie games. They self-funded and self-published their game, *Hellblade: Senua's Sacrifice* (Ninja Theory, 2017), using an experimental business model that utilised some strategic partnerships and marketing tactics (Souppouris, 2015).

The game was a commercial and critical success (Taylor, 2017). They had put faith in their community by being transparent and their audience was responsive to that honesty. More so, they attribute the success of their business model directly to this positive, direct-to-consumer relationship which they cultivated to help promote the game. Furthermore, they go on to suggest that by working directly with their customers they were able to secure a win-win

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situation for themselves as developers and their fans as consumers, without any publisher interference (Ninja Theory, 2017).

Ninja Theory created a call to action for consumers and developers to support new business models, with an ethical message of hope to companies such as their own, asking them to reevaluate their business models in the wake of a fast-changing market (Taylor, 2017).

The Industry Responds

Peterson (2015) points out that top publishers are not blind to the power of experimenting with different business models and are often touting games as a service. *Call of Duty Online* (Activision, 2015) being a significant case, where the number one selling, annualised game franchise is being repackaged under a F2P variant for the Chinese market, who are culturally more receptive to F2P games. Most online titles now have business models that make recurring revenue a staple of their design, giving publishers bigger profits and reduced risk.

Taylor (2017) contrasts the performance of AAA game companies against Ninja Theory's new model, noting that they both have had overwhelming successes with their *games as a service* and *independent AAA* business models, respectively. However, Digital River (2017) reports that games as a service revenue models tripled the value of the games industry. While this is good news for the health of the industry it could cause a conflict of interest, as the building negative sentiment around micro-transactional models was a central debate among the industry in 2017.

Industry pundit Jim Sterling (2018) voices his anger at the conjunction of these revenue models alongside full-priced games, calling them "greedy" and "unethical". Industry critics such as Yongyea (2018) perch close to the controversy around in-game purchases that some argue are exploitative and harmful. Empowered by online global communities these critics readily incite outrage as they pick apart the industry's responses. Meanwhile, worldwide governments weigh in on the similarities between such systems and gambling (Gambling Commission, 2017). Others still warn of predatory practices but argue that the rising cost of AAA development will bring new business models to the table and that it's up to consumers to support the ones they agree with (ExtraCredits, 2018).

Looking Outside the Industry

Perhaps lessons could be learnt from business models used in other software industries or beyond. *Facebook* and *Google* are obvious examples of innovative business models producing world-changing results. In both models the users are the product, with access to them being sold to advertisers and marketers.

One possibly transferable example is *GitLab's* radical open-source business model, which has accelerated its success and attracted the hard work and good will of thousands of developers, all of them remote, some paying customers, who then contribute to building a better product directly (Reed, 2016). They changed parts of their business model to ensure they remained a relevant competitor in the market (Chen, 2016). Proving that even a small salaried team, backed by a strong enthusiastic open-source community, can be a major competitor to large players in an industry, given enough time and the right strategic choices (Degeler, 2014).

Conclusion

The internet unlocks lucrative new business models, allowing companies to better understand and serve their customers' needs. Dixon (2015) argues that companies across all media industries need to pay attention and recognise the potential of experimenting with innovative new business models. Geigner (2015) attributes much of the games industry's success to the acceptance of and experimentation with innovative business models.

Lautjärvi (2013) predicts that as prevailing business models homogenise the industry towards high risk, high budget AAA or smaller budget indie titles, the mid-size developers will disappear. However, he remains optimistic that this new equilibrium will create a vacuum of opportunity that startups can exploit with new business models that change the dynamic once again. However, since new business models are highly experimental, McGrath (2010) cautions that it is best way to design them in a way that recognises their fundamental uncertainty and to keeps the costs, and therefore the risks, contained.

There seems to be healthy mixture of business models in the games industry, at all levels, from AAA to indie. Some models are, or are becoming, dominant at each level, mainly driven by the profitability or sustainability of those models and the needs of the businesses they serve. There is resistance to change and mistakes being made, from the developers to the publishers to consumers. It could be argued that all that commotion is ultimately being caused by the industry doing what it does well, implementing and experimenting with new business models. The problems may be symptomatic not of an industry that is getting it wrong, but one that working through some growing pains as it expands to meet its newly discovered economic potential.

There may soon be even more room for business models to be join the fray, with arguably some of the world's most successful digital business models being relatively unexplored by the video game industry at large. The next big idea in business model innovation could already be lurking, or more accurately, dominating in other markets already.

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