The End Is Near!

In the current economic climate, we are bombarded with numbers at every turn. And with the exception of declining oil prices, it is difficult to find something in the media to get excited about.

Every day for the last quarter of 2008 we heard of studio closings, layoffs, and reduced publishing budgets, while at the same time hardware and software sales were up as much as 22%, depending on which source you want to believe. Consumers are definitely “nesting,” and that works in our favor, as does the fact that games represent one of the best entertainment values per hour of all media forms. **Why then, one asks, does everyone seem to be feeling a pinch?** And when can we reasonably expect it to end?

Even more important, **what can we do to make sure we are still there when it does?**

To reach reasonable conclusions to any of these questions, it pays to understand the normal cycle of our industry and how that cycle is being disrupted by external factors. The videogame industry has the unique characteristic of being both seasonal and cyclical. We will deal with cyclical issues in a moment. With respect to the seasonal nature of the industry, the two heavy selling seasons are summer and Christmas, much like the movie industry. To have product ready for these seasons, development must begin anywhere from 1-2 years prior to the projected on-sale date and, for some AAA titles, even sooner. Some platforms allow shorter development timelines, but these are reasonable benchmarks for our analysis.

Because of this timing, retailers had no shortage of product in 2008 for either of the key quarters, as all of that product had been funded and developed before the gyrations of the financial markets began in earnest. In fact, there was a glut of product, particularly for the Nintendo platforms and, to a lesser extent, the Xbox 360. **Whenever the market gets flooded with product, irrespective of other factors, it leads to some consolidation.** Mid-tier and smaller publishers can’t market their products as effectively as the larger publishers and also lack the leverage the larger publishers have in getting their slates on the shelf.

In this environment, overall sales may be healthy and even growing, but the winning titles are typically concentrated in fewer hands. For Christmas 2008, external factors have exacerbated the normal cycle because of vast contractions in the retail sector as a whole, declining market caps in the publicly traded publishers, grossly reduced marketing budgets across the board, the evaporation of lines of credit, and the retail sector slow paying publishers, which has a trickledown effect on all the supporting players in outsourcing and independent game development. **Sounds pretty bleak, right? Well, this is only half the story**. The second half becomes clearer when one understands the cyclical nature of our industry.

Microsoft, Nintendo, and Sony typically release new consoles every 5-6 years. Each release needs good content support in order to maximize sell-through of the hardware during the first two years. To do this, publishers invest a good chunk of revenue from the last couple of years of the current generation software titles into research and development for the new platforms. Launch titles sell well typically because there is limited choice for consumers during the first year of a platform, which eases considerably during year two. Years three and four of a platform life cycle are typically when publishers make their greatest profits as the installed base for a given platform reaches mass levels but the price point for individual titles remains high. This is also the time when mid-tier publishers flourish by offering lower-price alternatives to the AAA releases, which consumers snap up and play through while they are waiting on the next installments of their favorite AAA franchises.

As we go into years five and six, both the glut of available product and anticipation of the upcoming next-generation hardware releases combine to drive down price points, and therefore margins across the board. This is occurring at the same time publishers need to begin investing in titles that support the upcoming hardware releases, as was mentioned previously. In this particular cycle, the economic downturn coincides with the point when publishers are supposed to be making their biggest profits and putting their war chest to work preparing for the upcoming hardware.

More bad news, right? Well, not entirely, as there is another piece of the puzzle to examine as well.

Publishing entities undergo another cycle of expansion and contraction naturally and repeatedly throughout the history of our industry. When market cap and balance sheets are high, publishers almost always go on merger-and-acquisition binges, sucking up the best and brightest independent development teams and capturing more of their production capacity in-house. Though not always, very often this is to capture and control franchise-level intellectual properties that the independent developer owns, and therefore recapture royalty streams directly back to their bottom line. Once acquired, these studios are often asked to perpetuate the same IP beyond their own appetitive to do so, which can lead to staleness, retention issues, reduced sales, or simple erosion of the creative entrepreneurial spirit that made the studio a great acquisition target in the first place.

EA learned this last point the hard way with Westwood Studios and other former independents, and CEO John Riccitiello made a big point about EA's commitment to not repeat those mistakes following their acquisition of Bioware/Pandemic. This cycle of inorganic growth continues until operating costs either threaten or exceed profits for a period of time; then publishers begin closing or selling off some of those same studios. This outpouring of talent to the independent development community both reinforces the rosters of existing independents and also recombines into new independent development studios. Publishers with reduced capacity use external resources more and as margins and profits improve again, the whole cycle repeats itself.

The major difference between how this cycle plays out normally and how it is playing out this time is one of scope.

Typically, this cycle plays out in individual publishers at different times, and there are always suitors in the wings with better results ready to snap up bargains and/or immediately act as publishers for newly formed independents of high quality. In today's climate, many independents have already had to lay off some personnel because publishers unexpectedly cancelled existing projects or found themselves unable to pay milestones on time. As such, much of the recently freed-up talent won't immediately find homes in existing studios. And, as for newly combined studios, where there is always inertia in landing the first few projects because of the collaborative nature of software development, where team dynamics are more important than individual experience, the situation is amplified by having many more risk adverse publishers than normal.

Now things just sound desperate, right? When you put all of these trends together, it seems like the "Perfect Storm," but, in reality, the horizons are already clearing and **THE END IS NEAR!**

Fear and paranoia are already being overcome by market reality, and the sheer inertia of our $50- billion market propels us forward. Interactive entertainment is not going away and too much has been invested already to allow it to languish in uncertainty in the selling seasons to come.

Coming out of the holiday season, we at FOG Studios have spoken with dozens of publishers, all of whom are actively planning their downstream slates, and many of whom are already behind the power curve on products they should have green lit in Q4 but failed to do so because of market uncertainties. The scramble for development resources and talent has begun again in earnest. Expect more conservative production budgets than may have been the case a year ago, but developers who have re-invested in their engine technology and process efficiencies should have no issues with the temporarily reduced margins on individual projects.

At the same time, increased digital distribution capacity is easing some of the dependency on traditional retail channels at precisely the right time. Hardware manufacturers should still seriously consider lowering their third-party manufacturing costs, as well as their digital distribution royalties in order to buttress third-party research and development investment in anticipation of the next platform transition.

But, otherwise, we are beginning to see the signs of the turnaround. Decisions being made now influence our sales 1-2 years down the road, and with virtually all the economic indicators pointing to general recovery in the latter half of 2009, no one who expects to be around then can afford not to have product working in the market at that time. So how do you survive from point A to point B and beyond safely? **Honesty, Integrity, Transparency, and Relationship!**

Anyone who approaches the publisher/developer relationship from an adversarial standpoint at times like this is going to lose in the long run. **When fear grips the marketplace, self-interest runs high and integrity can be diminished.** Publishers can have a tendency to cut heavily one-sided deals that look good on paper but are totally unrealistic in execution. Developers who need cash flow however they can get it sometime sign up knowing from the outset that overruns or scope changes are going to happen, but they don't have alternatives and it beats closing the studio down. Landing the deal solves the short-term problem but makes the long-term problem twice as large.

Because neither party behaved with integrity during the negotiation, both are eventually damaged, both in terms of reputation and fiscally as a rule. The repercussions of being treated unfairly in either or both directions extend well beyond the climate of fiscal austerity that precipitated them, so ultimately it is much better to forgo negotiating positions and truly focus on needs and transparency. When both parties come to the table transparently expressing what they need to make something work, either unrealistic expectations are quickly resolved and the parties forge a much stronger long-term relationship of mutual trust that can be expanded when times improve, or neither side wastes an inordinate amount of time investing in a relationship that is ultimately doomed to failure.

The second major point that is needed to survive economically difficult times is integrity-based also, and that is **of having a sense of relationship with and responsibility for the health of the community as a whole.**

The developer/publisher relationship is a symbiotic one. A strong independent development community fosters a strong publishing community and vice versa. Neither can exist in a vacuum. Granted, both communities go through the aforementioned cycles of expansion and contraction, but examined over the continuum as a whole, the long-term growth of both is virtually assured. Company names may change but the people don't, there are just more of them over time.

As such, it is the FOG view that, in the long term, **collaboration benefits the whole health of the industry better than competition.** When you come across a project that is not right for you for any reason, you serve everyone's interests better by staying in the game and trying to help that publisher or developer find the right solution than by just turning a blind eye at that point. Long-term investment in relationships benefits everyone better than short-term focus on individual- or project-based goals.

You've heard it put another way all of your life: "When times are tough, you find out who your friends really are." I for one like having lots of friends who stand by my firm and me when years like 2008 come around -- and you should too. But you don't build them without investing in those relationships all of the time. **2009 marks our 30th anniversary in this business,** and whether I am personally around to see it or not, I am confident FOG will be around for 30 more at least.

Why can I have such confidence? Because we never knowingly set up a publisher/developer relationship with unrealistic expectations on either side of the deal, because we value the trusted relationships we have built more than the profitability of any individual deal, and because we freely pass opportunities our teams can't handle to groups with the bandwidth and expertise to take on those projects. **Honesty, Integrity, Transparency, and Relationship, folks, it's that simple.** I encourage everyone to live by this philosophy, and live you will, smaller at some times and larger at others, but nevertheless alive.

Good Hunting, and drop some extra meat on your needy neighbor's table when the opportunity presents itself. You will never regret it!