

# Competitive Strategy in Game Consoles

*Jay Conrod, Klimka Szwaykowska; Mar 7, 2007*

The interactive entertainment industry has grown remarkably quickly in recent years. Since 2001, the market has been dominated by three major players: Sony, Microsoft, and Nintendo. Of these, Nintendo had the smallest market share, even though the company had historically dominated the market. In 2004, faced with strong competition from larger and wealthier rivals, Nintendo had to come up with an innovative strategy to maintain profitability. At that time, the optimal strategy was differentiation into a neglected segment of the market: casual gamers who wanted a simpler, more intuitive gaming experience.

## **Nintendo's status in 2004**

Unlike its competitors, both of which are powerful players in consumer electronics and business software, Nintendo is primarily a video game company. Nintendo has three main products: consoles, handhelds, and software (games).

Typically, only one console product is sold at a time; production of one generation ceases shortly after the next generation is released. Nintendo's console in 2004 was the GameCube, which had been on the market for three years. The competitors' products (Sony's PlayStation 2 (PS2) and Microsoft's Xbox) were approximately the same age, but had several advantages over the GameCube. Though they cost a little more (\$150 for the Xbox and \$130 for the PS2, compared to \$100 for the GameCube), they had more advanced networking and media-playback features. By March 31, 2004, only 14.6 million GameCubes had been sold worldwide (Nintendo 2004 Annual Report).

Nintendo's position was stronger in the handheld gaming market. The handheld Game Boy Advance (GBA) was introduced at roughly the same time as the GameCube, and sold 51.4 million units by March 2004.

Nintendo develops software for all of its gaming systems. Although software is expensive to develop, it can be sold at a high margin. Nintendo has a wide variety of recognizable franchises such as Mario and Pokémon that keep sales strong. However, most of the software developed by Nintendo was targeted at a younger audience and does not appeal to older gamers.

## **Porter Forces in the game console market**

### ***Customers***

The customers in this market are almost all individuals or families who purchase consoles from Nintendo through retailers. Customers tend to buy only one console at a time. Since console manufacturers suggest retail prices over entire countries or regions, individual customers have no bargaining power. Software purchased for one console cannot be played on other consoles so switching costs are high; if an individual wants to play a particular game, he or she is usually locked into the console that plays it.

By 2004, there was a tendency for console games to be increasingly complicated. Becoming involved in a game required a significant time investment to learn how to play. Game companies aimed mainly at servicing the "hard-core" demographic which enjoyed this kind of game. Relatively few games were produced for the larger demographic of "casual gamers".

### ***Suppliers***

Suppliers are companies which make hardware and games for the consoles. Nintendo designs some of the hardware components for its consoles, but manufacturing and assembly are

often outsourced, and many components are purchased "off the shelf" from large companies. This keeps costs higher than competitors like Sony and creates a threat of forward integration by parts suppliers, who could potentially manufacture their own consoles. Switching costs are also high, as Nintendo software is made to be compatible with technologies supplied by the outside companies.

The situation is different for software. Nintendo does much of the game development for its consoles, though most of its games are made for a fairly young audience. It also licenses a software development kit (SDK) to outside game developers. In a manner, these firms are Nintendo's customers. Firms which have made successful games in the past will probably have some bargaining power in this transaction, since Nintendo is interested in keeping their services for future game development (as will be discussed below, games are an essential complement for game consoles). Overall, Nintendo's SDK tends to be priced lower and have better support than similar packages offered by competitors.

### ***Threat of new entrants***

The console market has a strong threat of new entry. There is very little patentable technology in game consoles, and most consoles tend to have similar features and functionality. The greatest barrier to new entry is the economy of scale; producing consoles is prohibitively expensive unless done on a very large scale. In addition, a potential entrant would have to develop games to sell alongside the console. An exceptionally strong marketing campaign would be required since Nintendo, Microsoft, and Sony are already household names in many countries, which gives them a strong advantage in this sort of competition. Nevertheless, many large companies could potentially enter the market, as Microsoft did in 2001 with the introduction of the Xbox.

## ***Substitutes***

Though they have negligible bargaining power, customers have a wide range of available substitutes, spanning over all sorts of possible forms of entertainment. In addition to competitors' products available to them, they may choose television, movies, PC games, board games, literature, sports, etc., in their leisure time. Thus, game consoles have to make an effort to be wanted since they are not needed.

## ***Complements***

Strong complements are an important part of getting customers to choose game consoles. The greatest complement to consoles is games, without which a console is useless. Controllers and memory cards are also complements, as is the Internet, which allows players to network with each other and play video games with their friends. Nintendo's handheld devices are also a complement for the consoles: the GBA could be connected to the GameCube, unlocking special features in some of the games.

## ***Rivalry***

Overall, there is strong rivalry in the console market. In 2004, there were three main competitors, all going after the same general audience. Product diversity was fairly low; the most significant difference between the consoles manufactured by Sony, Microsoft, and Nintendo was in the games available for each. This led to price competition that drove prices down from the initial \$200-300/unit to \$100-150/unit. Nintendo, as the weakest competitor, would have suffered most loss from price competition. This situation gave a fairly strong indication that Nintendo would have to stop competing directly with Sony and Microsoft if it was to remain profitable.

## **Strategies Available to Nintendo**

In 2004, a number of potentially successful strategies were available to Nintendo. It had become clear that a "stay-the-course" tactic would not allow Nintendo to beat Microsoft and Sony. Vertical integration presented the opportunity to lower costs and expand into other markets at the same time. Exiting the game console market would allow Nintendo to continue making money on software and handhelds. A third and ultimately most promising strategy was differentiation from competitors, which would enable Nintendo to capture other market segments that had been largely ignored.

### ***Vertical integration***

Sony entered the game console market when it introduced the PlayStation in the mid-90s. Sony was able to make much higher margins than Sega and Nintendo because it was already a large manufacturer of consumer electronics. Sony could design and manufacture parts for the PlayStation in-house while Nintendo had to buy parts off-the-shelf and outsource manufacture and assembly. This became a significant weakness for Nintendo which could be addressed by vertical integration, both into manufacturing and Internet service

Integration of manufacturing has a number of advantages. Although it would cost a significant amount of money to expand, Nintendo would be able to dramatically reduce the cost of its consoles as well as complementing products such as controllers. A lower cost would also allow Nintendo to introduce additional features to its consoles while maintaining lower retail prices than competitors. Nintendo could then expand into other consumer electronics markets such as cellular phones and digital music players.

Integration of Internet service would involve developing an online gaming service similar to Xbox Live. This would greatly enhance the multiplayer capability of its consoles while providing an additional source of revenue: subscriptions.

Although both of these integration tactics could be effective, they would not allow Nintendo to beat Microsoft or Sony. Nintendo would never be able to match Sony's capability or experience in manufacturing consumer electronics. Adding Internet services for newer consoles would only be adding a feature that Microsoft already provided to its customers. It would be unwise for Nintendo to base its new strategy on vertical integration, when both of its competitors were already very experienced in many other markets.

### ***Exit the market***

After Sega's Dreamcast console flopped, Sega decided to exit the game console market entirely while continuing to develop software for other consoles. This proved to be a fairly successful strategy. Like Nintendo, Sega had several popular game characters like Sonic the Hedgehog. The Dreamcast had proven to be a money pit; rumors had surfaced that Sega was losing money on each console sold. Slow sales drove down software sales as well. Sega games had the potential to be much more successful on a more popular console, and Sega could reduce its costs by ceasing hardware development.

Although Nintendo's GameCube was doing poorly against competitors, sales were still strong for handhelds and software. There were no significant exit costs in the market, so the transition could be made cleanly by simply halting console hardware development and developing software for other platforms. Nintendo would still make a significant amount of money on high-margin software development and would still dominate the handheld market, at least in the short-term.

The main disadvantages to this strategy are that it leaves Nintendo cornered in the long-term and that it does not hold the same potential for profitability as other strategies. The handheld market was still vulnerable, and Sony had already introduced the PlayStation Portable as a competitor to the Game Boy Advance. Software sales could sustain Nintendo indefinitely, but would never restore the company to its former position. As such, this strategy should be used only as a last resort. Sega was forced to exit the market because it did not have enough cash to vertically integrate or to differentiate significantly from Nintendo and Sony. Exiting the market allowed Sega to survive, but nothing more.

### ***Differentiate from competitors***

In the last several years, the game market had grown somewhat stale, although profits have remained high. Many game developers were focusing on the "hard-core" demographic: customers who were willing to invest a lot of time and money on a narrow range of games. Many new games were sequels, offering very similar game play to their predecessors. At the same time, games were becoming more complicated and difficult to learn for casual gamers.

This presented Nintendo with an opportunity: create a console and games that appeals to people who had been ignored by Microsoft and Sony. Although hard-core gamers were much more willing to spend money on games, they were outnumbered by casual gamers. The console would have to be easier to use than its competitors; a controller with 15 buttons would not be an option. The games would have to be easy enough to learn that someone who had never used a console before could learn and enjoy a game within a few minutes. Both consoles and games would also need to be cheaper to be more appealing to a wider range of customers.

The primary advantage of this strategy is that it is one that Microsoft and Sony cannot effectively copy. In order to appeal to the hard-core market, both companies were competing on

hardware performance and features. In order to reduce costs enough to compete with Nintendo, they would need to abandon these goals, alienating their customers.

## **Why differentiation was the best strategy**

The Nintendo Wii was originally conceived in 2001 shortly after the release of the GameCube. At the time, it was known by its codename "Revolution." It was first released on November 19, 2006, in North America. Its key feature was a new form of player interaction, nicknamed the "Wiimote": a wireless controller that could detect its position in space. In addition to using buttons and joysticks to control games, users could swing or point the new controller as they would with a sword or tennis racket. This provides gamers with a more enjoyable experience and much more intuitive interface than other consoles, especially if the game involves swinging swords or tennis rackets. Games for the Wii were also targeted at a broader audience, although few games have been released to date. The Wii is also much cheaper than the other consoles. It can currently be purchased for \$250, less than half of the price of the PS3.

In the months since its release, it is estimated that the Wii has sold 4.15 million units, overtaking both of its competitors. Although Nintendo may not be making such a large profit on each unit as Sony or Microsoft, a larger number of consoles on the market will drive software sales in the future. The only thing currently limiting sales is manufacturing capability, and of the three consoles in the newest generation, the Wii has been in shortest supply.

Microsoft and Sony, as predicted, continued to appeal to the hard-core market with very advanced consoles. For instance, Sony bundled its Blu-ray optical disc technology with the PlayStation 3 and included IBM's Cell processors as the CPU, causing the price of the PS3 to be between \$500 and \$600. Microsoft included a wide range of media-center and online capabilities

in the Xbox 360, expanding into the broader home entertainment market. While Microsoft and Sony's strategies will undoubtedly be highly profitable, they will not be able to compete directly with Nintendo without alienating their existing customer base.

## **Sources**

*January Game Sales Explode; Wii Dominates.* GameDaily BIZ. Feb 21, 2007.  
<http://biz.gamedaily.com/industry/feature/?id=15294&ncid=AOLGAM000500000000021>.

*Nintendo Says Women, Elderly Key to Wii Game Player.* Bloomberg.com. Sept 18, 2006.  
<http://www.bloomberg.com/apps/news?pid=20601080&refer=asia&sid=a0kkIJ1sNgDI>.

Nintendo Annual Reports, 2002-2006. [http://www.nintendo.com/corp/annual\\_report.jsp](http://www.nintendo.com/corp/annual_report.jsp).

Best Buy Online Store. <http://www.bestbuy.com>.