

## [Opinion](#) - Guest Articles

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# VCs step up their game

By Peter Moran, DCM

Like a gamer “leveling up,” venture capital is poised to finally have a major impact on the gaming industry.

While there have been some good exits in recent years, including **Giant Interactive Group’s** \$887 million debut on the New York Stock Exchange in November 2007, gaming has not traditionally been an emphasis for venture investors.

That’s changing, however, and the pace of future investments is accelerating.

Having tripled in annualized revenue over the past decade, no one disputes that the gaming industry is huge. Driven by traditional incumbents like **Nintendo** and **Sony** in hardware, and **Electronic Arts** and **Activision** in software, industry sales were nearly \$19 billion in 2007—about half for PC and console games, and game console hardware, respectively.

Individual titles have also racked up impressive numbers. **Take-Two Interactive’s** Grand Theft Auto IV game grossed more than \$500 million during the first week. That makes it the fastest-selling, first-week entertainment product launch ever, surpassing any movie or book launch.

Even though industry growth has slowed to 6% year over year, specific niches are still growing rapidly. **NPD** reports the “family entertainment” game genre grew 110% in 2007, from 8.3% of all games sold in 2006 to 17.2% during the study year. **Jupiter Research** forecasts that the global market for games on mobile devices could triple between 2007 and 2009.

These growth opportunities command eye-catching valuations. Long-time heavyweight **Electronic Arts** attempted this year to take over Take-Two for \$2 billion. **Activision** successfully acquired **RedOctane**, maker of the hit Guitar Hero series, for \$100 million—before the breakout success of Guitar Hero III.

Venture investors have not been major players in most deals so far. One exception is venture-backed **Glu Mobile**, which went public in 2007, raising \$84 million. For the most part, venture capitalists have considered gaming a niche investment, and game entrepreneurs have, by and large, returned the favor.

## Time To Level Up

As gaming increasingly moves online, perennially dominant players in the console realm face challenging, paradigm shifts that startups are often better prepared to overcome. Traditional patterns and channels of distribution, and development and market segmentation become largely irrelevant. Those who can truly leverage the Internet's capacity for continuous product evolution, global reach and social interchange will win.

Startups have pioneered new models in which games are played on sites using Flash or other technologies; and their games don't need to be delivered in full form. Other companies use the Web to digitally deliver copies of games using peer-to-peer networks to distribute game files that sometimes stretch into gigabytes in size. These methods augment or replace the traditional retail store delivery of disks.

Telling great underlying stories or developing innovative game play remain paramount, but the rise of the broadband-connected PC as the gaming console is changing other aspects of

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traditional game development.

For more complicated massively multiplayer online games (MMOGs) or advanced casual games, single-title development costs can be more than \$25 million. However, innovative developers are pioneering ways to leverage digital development platforms—the physics and rendering engines, character movement capabilities and other features that underlie all titles.

Some server-based games release several levels of a game and then use real-time game play to enhance earlier games levels and incrementally deliver more levels. This allows faster time to market and the ability to evaluate user feedback before pouring in more development dollars.

**Trion World Network**, a publisher and developer of real-time server-based games, which has attracted more than \$100 million in capital and investment by three of the world's top five media companies, plans to release titles in 2009 that fully leverage these capabilities, using gamer feedback to evolve games and in step with other media like TV.

Online, centrally served games also solve nagging problems including piracy, which continues to be an enormous issue for traditional packaged, PC-based games.

Online games also change the economics of development and delivery, allowing for profitable targeting of smaller niches. While traditional game developers continue to primarily target teen and 20-something males, many online titles have found new audiences. MapleStory appeals to 3rd grade girls, while RuneScape appeals to boys from 4th through 7th grade.

Niche markets can translate into significant market value. Case in point: **Club Penguin**, a kids-only online gaming company, was acquired last year by **Disney** in a deal that, with performance benchmarks, could total \$700 million.

## Challenges and Solutions

With increasing market segmentation and consumer demand for more entertainment options, capturing and maintaining a loyal user base is a challenge for gaming companies—new and old alike. What happened to TV—where scores of cable TV channels split the broadcast market traditionally dominated by the three major networks—is now occurring in online gaming.

One solution is to build strong brand loyalty to a connected genre of casual game titles. For example, **PlayFirst** was able to make Diner Dash a game category leader whose games appeal primarily to the female demographic. The original title has enjoyed multiple releases and is now extending to related titles like Wedding Dash.

The move to online gaming also lets marketers leverage fast-changing Internet usage patterns such as social networking. While console games let gamers text or voice chat, they are limited to communicating with current players.

The newest generations of games integrate instant messaging (IM) and social networking applications. This allows games to spread virally through chatting with friends not involved in the game. Today, users only need IM clients from the likes of **Facebook**, **AOL** or **Yahoo**, and players can also go to specific websites and view progress by their friends from any portal without actually entering the game.

Lastly, the Internet's simultaneous access to behaviorally different markets around the globe presents challenges. Japan continues to favor console development because of home-based brands Nintendo and Sony, and remains the center for original character development for many

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games.

Korea is the pioneer in online game development and continues to be a primary center. According to **MSNBC**, Korea had the highest density of online, fee-based players in 2007—an estimated 17 million people in a country of 48 million were regularly gaming.

Conversely, China has, by far, the world's the most online players of any region, but reliance on Internet cafes and dramatically less consumer willingness to pay has required alternative revenue models found nowhere else.

Long term, the United States and, more recently, Western Europe, have shown that they have the largest revenue potential for online gaming.

New entrants are identifying models that accommodate regional differences and leverage them. For example, **Outspark** and **IGG** are growing rapidly as they find top quality online games developed in Asia and publish them in Western markets. Studying and understanding the differences in these markets is crucial, as is a solid grasp of the differences in each country in Asia.

## **From Noob To Vet**

Returns in the next few years will likely reveal that a select number of venture capitalists have abandoned their days as a “noob” (gaming vernacular for “newbie”) as investments begin to bear fruit.

The pace of investments is already growing. In 2003, eight investments in gaming companies totaled \$102 million, according to **Avista Partners**. By 2006, the number of deals grew to 36 for a total of \$266 million. In the first half of 2007 alone, 34 deals indicated the pace nearly doubled. This increasing level of investment should start to pay off in the next three to six years, given typical venture return timing.

The real excitement lies in the potential scale of these exits, with some outcomes possibly on par with, or exceeding, **YouTube**. Although that may seem brash, the sheer number of gamers and their intense interaction with successful games will allow select titles to dominate their segments in the same way that YouTube owns video sharing with potentially far greater monetization.

However, predicting the breakthrough titles remains an art. Venture investors will diversify their risk by investing in a small set of potential winners, and will focus on novel game segments or business models that leverage the fundamental dislocations still occurring.

The opportunity is there, as gaming under the influence of the Internet continues to profoundly evolve. A new league of leaders is emerging and venture investors are poised to play a bigger role in backing the emerging leaders.

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