

Video Games and the Shaping of Industrial Transformation: Square Enix

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Yoichi Wada

President and CEO, Square Enix Holdings Co., Ltd.

Mr. Wada spoke at Columbia Business School about the rapid technological transformation of the global video game industry and the birth of new business models that promise significant growth prospects for the industry. This Center on Japanese Economy and Business (CJEB) symposium was moderated by David E. Weinstein, Carl S. Shoup Professor of the Japanese Economy at Columbia University and associate director for research at CJEB. Rita G. McGrath, associate professor at Columbia Business School, joined as the discussant.

Glenn Hubbard, Dean and Russell L. Carson Professor of Finance and Economics at Columbia Business School, provided opening remarks, congratulating CJEB on 25 years of bringing together thought leaders from various fields and pointed to the Center's role in strengthening a growing alumni network in Japan. Dean Hubbard then stressed the importance of the video gaming industry, which has already created great interest among the students and faculty of the School with the remarkable pace of its technological advancements in recent decades.



Dean Glenn Hubbard

Mr. Wada began his presentation by providing a brief overview of Square Enix’s growth within the broader video gaming industry. At the turn of the century, the video gaming market not only saw unprecedented advancements, but also experienced substantial transformation that allowed the merger of Square and Enix in 2003 to benefit from synergistic growth opportunities. Mr. Wada classified this industrial transformation into four distinct eras, describing their progression from a brief initial Arcade Era to a Game Consoles Era dominated by Nintendo’s low-priced home game consoles, thus setting the industry standard for individual gaming devices. As devices gradually expanded their functionalities and capabilities beyond game-playing, the present General-Purpose Device Era came into being. Wada predicted that the industry, far from stagnating, is slowly moving towards a fourth era, which he terms the Network Era.

The ramifications of the Network Era, according to Mr. Wada, are three-fold. First, the evolving practice of micropayments will have a significant impact on the industry. In this instance, the economic law of one single price disappears, as consumers are now allowed to price in accordance with their product satisfaction. Second, the transferability of games between multiple devices introduces an important complexity into the task of separating the process of billing from that of identification. Lastly, the gradual disappearance of physical media is changing the industry’s business model from selling finished products to providing a long-term service, in addition to making pirating more difficult.

Mr. Wada emphasized the importance of innovation management during this era of dramatic “ecosystem change” within the video gaming industry. He likened the role of the manager in this changing industry to that of a chemist, defining and preparing the elements that would be required in a shifting industrial ecosystem, and then designing the environment for the chemical reaction to take place, while being attentive to necessary catalytic drivers.



From left to right: translator, Yoichi Wada, Rita McGrath, David E. Weinstein



From left to right: Yoichi Wada, Rita McGrath

Professor McGrath observed that accessing growth opportunities often requires developing a new business model that more adequately identifies and keeps up with individual needs and user experience. This is needed when next-generation models begin to exhibit less and less improvements, or when the dominant consumer criteria for products change. In this regard, businesses often belatedly make changes to their strategies only when problematic figures show up in

accounting balances and then find themselves outmaneuvered by firms with more foresight. She gave the example of Netflix Inc., which pre-emptively transitioned from its DVD-by-mail business to streaming and on-demand products as it perceived a rapid growth in “cloud” technology and a commensurate industry-wide shift to these new services. The case of former Blockbuster Inc. provided a stark contrast, in which the latter’s inability to adapt to changing consumer needs led to its relatively swift demise.

Indeed, Professor McGrath lamented that many companies cling to old models for far too long, causing them to miss both threats and growth opportunities as other companies in their industries graduated from conventional business models to competitive business models. She commended Square Enix’s attractive business model, particularly its relational customer strategy, its high emphasis on customer experience, and the “stickiness” and relevance of its products.

Question & Answer Session:

Professor Weinstein opened the Q&A session by remarking on the revolutionary phenomenon of micropayments, and wondering how profits can be sustained when businesses are essentially generating games for free.



Rita McGrath

Mr. Wada revealed that in a “free-to-play” business model, around 5-15% of customers are willing to pay for the games. Since pricing is flexible according to their satisfaction, some customers may spend more than they would for a boxed product, thus propping up profits. Drawing an analogy on the different prices of packaged drinking water in the market, Professor McGrath remarked that customers have learned to monetize the same type of product depending on their relative needs, a trait that allows for profitability even in flexible pricing models.



Mr. Wada also noted that while micropayments remain a relatively new feature of games in the industry today, the ability of customers to play these games on different devices has raised the specter of micro-transactions. In Japan, where cellphone games are already mounted on micropayment platforms and incorporated with cellphone billing processes, it was convenience that drove such a payment system rather

than the attraction of the games themselves. On the other hand, console-makers, which typically host more “serious” games, have yet to incorporate the micropayment system on their console devices, even though micropayments should ideally be available for any gaming transaction.

An audience member asked if Square Enix planned on focusing on the “hard core” gamers, the more casual “soft core” players, or both.

Mr. Wada pointed out that these two types of games have their own respective growth markets. Both types are differentiated not in their complexity, but on the amount of time and money that customers may choose to spend. As such, markets are segmented based on customer time-usage. He maintained that Square Enix would continue to pursue opportunities in both hard core and casual markets, while acknowledging that a good understanding of these two markets is crucial for successful product segmentation. Professor McGrath asserted that businesses have often wrongly created customer segmentation models based on the different inherent attributes of the product, thus failing to take into account the different behavioral traits within its customer base.

An audience member raised concerns of piracy in the video gaming industry and asked what Square Enix was doing to combat it.

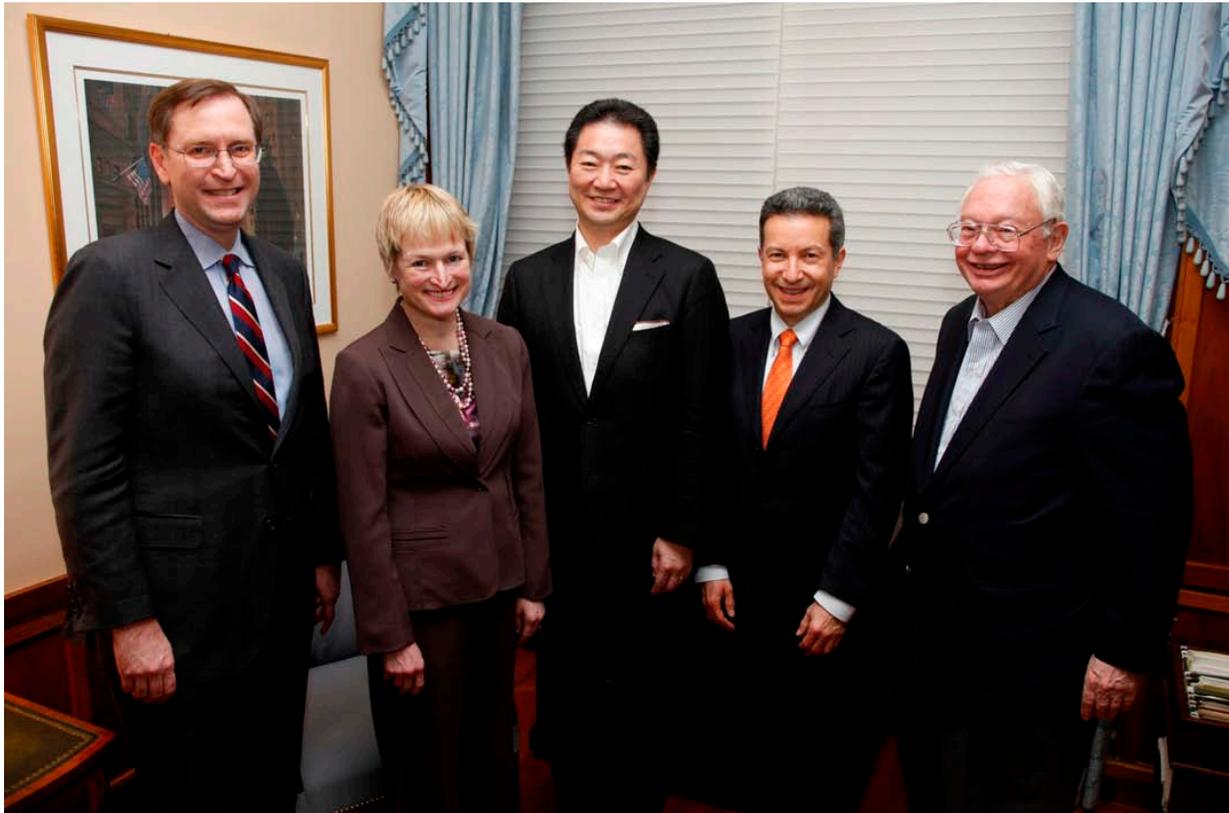
Mr. Wada responded that while Square Enix continues to distribute games via physical disks, legal secondary resale markets impact company profits, in addition to illegal piracy. He is confident that as the industry migrates away from physical disks towards network-based distribution, this problem can be mitigated since customer data can be more easily controlled and



David E. Weinstein

user experience cannot be easily copied. He warned, however, that the emerging risks with this new model would include leakages in personal information, candidly concluding that it is “not just in games that one has to vanquish monsters.”

Hugh Patrick, director of CJEB and the R.D. Calkins Professor of International Business Emeritus at Columbia Business School, closed the session by reflecting on the gaming industry as an example of a rapidly growing, dynamic industry that is forcing dramatic changes in business models and putting a renewed emphasis on innovation.



From left to right: Dean Glenn Hubbard, Rita McGrath, Yoichi Wada, David E. Weinstein, Hugh Patrick