

Why The Economics Of Social Gaming Are So Attractive To Investors

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In 2009, social gaming exploded onto the scene. EA bought

Playfish for more than \$300 million just a couple of weeks ago, and Zynga and Playdom (we're an investor in the latter) both raised large rounds of financing this year. Traditional computer gaming has been showing steady growth for a long time, but not the tremendous growth that the leading social-games companies have shown. What is it about social games that has enabled such a difference in trajectory over the last year, and why has it been startups and not the big established publishers that have led the charge? There are three key factors: development, distribution and discovery.

DEVELOPMENT

Making video games is now like making movies. The best video games (AAA or triple A games) now cost between \$30 million and \$50 million and can take three to five years to build. In an upside scenario, the returns are commensurate – Modern Warfare 2 **sold \$550 million** in its first five days. But videogame sales show a strong power curve – only the very bestselling games turn a profit. Games are a hit-driven business, and when the cost for a shot on goal is so high, and

it takes so long to see if the shot goes in, only the biggest publishers can afford to take the number of shots that are required to balance the inherent risk of whether a game will be a hit.

Social games show a very different profile. Social games can be launched in three to six months with a total development cost in the hundreds of thousands of dollars. Social-game developers have taken a leaf out of the web 2.0 page. They launch a game in beta, without completely fleshing out all elements of gameplay. If the game finds an audience, it will earn further investment in development. But if it does not, then the investment is stopped. This helps mitigate risk. Furthermore, developers know quickly if a game is going to work, and are able to iteratively launch new features based on actual data on what players like to do.

Because social games reduce development time by an order of magnitude and development costs by two orders of magnitude, they offer a very different risk-return profile for startups. A startup may find it hard to put all its eggs in one basket to build a \$30 million to \$50 million game. But they can certainly afford to launch multiple social games, and only one needs to be a hit to make a company successful. When competitive advantage lies with speed of development and expertise in building social games, startups have a real advantage.

DISTRIBUTION

More than 75% of console and PC videogame sales still come through retail. This is where the big game publishers add a lot of their value. They control retail distribution and can make sure that customers have an opportunity to buy the games that they publish. It's hard to buy a game if it isn't on the shelves at Walmart, Gamestop and BestBuy.

Again, social games show a different profile. Social games are played in a browser, so anyone who has access to the internet

can play the games right away, without having to go to a store or to pay anything. Facebook is the most popular platform for playing social games, but since it is free to join Facebook, and many people are already users of Facebook, there is virtually no friction in the distribution of social games. Anyone can play right away.

Furthermore, it may be stating the obvious, but traditional games are not free. A typical new release game sells for between \$40 and \$60. A prospective player would have to pay money to buy the game before he had played it (before he knows if he will like it). This creates a barrier to adoption as he needs to be pretty sure that he will like a game before he is willing to buy it.

Social games, on the other hand, are free to play. They make their money by upselling digital goods to the free players. So a player can try a game before spending any money, and indeed only spend money after he has established to his own satisfaction that he'll enjoy the game. That dynamic helps drive much more trial, and explains how Zynga now has **more than 100 million unique visitors** per month, which compares to the 8 million units sold of Modern Warfare 2, the best game launch of all time.

DISCOVERY

In the console-game world, discovery happens both through game reviews and through marketing. Marketing can be very expensive. On top of development costs, Modern Warfare 2 had a **launch budget** of \$200 million, including marketing and the cost of producing and distributing discs.

Once again, social games are different. One of the core elements of social games is their viral growth. Existing players enable new players to discover a game through invitations, Facebook feed posts, notifications and other communications channels. This discovery is free to the game publishers, beyond incorporating design elements into their games that facilitate viral growth

Game reviews for console games are free, but fickle. And the game-industry press mostly consists of hardcore players whose tastes reflect the traditional core-gamer audience. The readers of game reviews are also self-selected to be hardcore gamers. To some extent, this has caused games to cater even more to their core-gamer audience, making them ever more inaccessible to non gamers.

In contrast, the serendipitous avenues for discovery of social games mean that everybody (not just core gamers) is exposed

to the opportunity. I'm sure that just about every user of Facebook has seen feed items about games and been sent invitations to collect gifts sent inside games. This much broader exposure leads to the much larger player bases noted above. It also leads to a different style of gaming that is much easier for non-gamers to adopt.

Of course, advertising also plays a role in launching new social games. Zynga has begun launching all its most recent games with both advertising and cross-promotion blitzes, which has led to very steep growth curves for Farmville, Café World and Fishville. But once again, the amount that Zynga spends to launch a social game is one to two orders of magnitude less than what Activision (**NSDQ: ATVI**) spent to launch Modern Warfare 2. Indeed, several of the top-25 social games, including Happy Aquarium, Farmtown and Friends for Sale, have never had any meaningful advertising put against them. (We're an investor in Serious Business, the publisher of Friends for Sale.)

In such an environment, startups are able to play on more equal footing against bigger publishers.

These three characteristics of social games go a large way towards explaining why there has been such explosive growth over the last year in that sector relative to the traditional gaming industry, and why this growth has been dominated by startups and not the big publishers.