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Panel: Video Game Financing

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Alex Marquez

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Video Game Financing

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MODERATOR:
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PANELISTS:
Keith Boesky, Principal, Boesky & Co.
Alex Marquez, Director, Intel Capital
Stephanie O'Malley Deming, President, XLOC

Introduction of the panelists by Ms. Christ:

ROXANNE CHRIST is a partner at Latham and Watkins in their Los Angeles office. She is a leading attorney who has been recognized in the Legal 500 Guide in the area of video gaming and corporate transactions and advice.

KEITH BOESKY has distinguished himself in his non-legal practice as well. Keith has managed to get his fingers into all the pieces of the industry and do fabulously well. He has earned a fantastic reputation as an entrepreneur and an innovator. He also ran IDA for some period of time, which I think is a fantastic experience as an entrepreneur and seeing the gaming industry from its early stages.

STEPHANIE O'MALLEY DEMING is president of XLOC and is here representing the people who work in production and development. XLOC is a software management system that helps with the international versions of games. You can produce games simultaneously from the source language and other versions in other territories where it will be released. By releasing it simultaneously you can take advantage of the revenue increase from releasing the games worldwide simultaneously.

ALEX MARQUEZ works with Intel Capital and is here representing the venture capital community. He will give us insight into what the venture capital community is looking for and where he sees investments going.

Opening remarks:

MR. MCCOMBS: Welcome everyone. Welcome to Day Two. My name is David McCombs. I am the chair of the technology law practice at Haynes & Boone, and I also have the privilege of being the chair for the Institute for Law and Technology at the Center for American and International Law. The center was founded in 1947 and one of its claims to fame is it has one of the longest-running intellectual property law continuing legal education programs in the state of Texas. The center has coordinated on numerous programs with SMU and Professor Xuan-Thau Nguyen, and it is

also a great privilege to be collaborating on this program with Peter,Ron, and Guildhall.

Yesterday was a great day. We learned a lot of things. We learned that developers are recognizing that there is more out there than the core gamer, and that growth can be found in many other market segments. We learned that developers and retailers are focusing more on the differences between their consumers to sharpen their marketing message. We learned that there is a major change on the horizon from free-play games that is going to be dramatically affecting the publishers. We learned that a well-thought out licensing agreement is a lawyer's best friend. We also heard yesterday about the exciting reality that there is just more and more AAA breakthrough experiences by small developers. As a result of that, what we want to focus on today is some of the nuts and bolts of financing and business deals. We are very privileged this morning to have with us Roxanne Christ, who is a partner at Latham & Watkins in their Los Angeles office. And Roxanne is a leading attorney that's been recognized in the Legal 500 Guide in the area of video gaming, corporate transactions, and advice.

And I am going to turn it over to Roxanne who's going to in turn lead us.

MS. CHRIST: Some of these statistics are ones that most of you know about, but there are a lot of arguments about what are the right statistics and what are the right numbers. It is quite difficult to get public-source comparative statistics about games–versus-movies-versus-music-versus-other-content entertainment. The point to be made, as all of you know, is that it is growing and the rate of its growth is faster than these other forms of entertainment. And these form of entertainment are also converging, and that has many implications, including in the area of finance.

Global projection is the same for the raw materials that go into making tires. Why do I include that? We talk a lot about what the trends of the games industry are, and I think it is really important that when we talk about this, we view it in terms of the bigger picture of global growth and the demographics that drive that. It is not just Asia, and it is not just driven by the meltdown. It is the market in Europe, the unified market, which is a huge engine for growth. So when you think about what kinds of societies use a lot of tires, you can see that the growth of Asia and Europe compared to the United States, you can see growth rates reflect that as well. The games industry is a reflection of those larger trends. China has enormous growth projections for video games, hardware, software, and downloadable content available on internet cafes.

As far as market share, two of the biggest are Zynga and EE Studies, which was just awarded the World of Warcraft license and the Starcraft license last year. Needless to say, games are getting way more expensive and they are getting way cheaper as well. The way-more-expensive kinds are MMOs, and the way-cheaper kinds are the free-to-play social games like Farmville, where growth is incredibly explosive. The size of the teams that are required to make MMOs is growing enormously. At the other end of the

spectrum are games like Farmville and the games you might find on Zynga. They are seeing growth like we saw in the early days of Google. Twenty-eight million people visit it every day, and seven million people visit it every month. The Wii has been a total game-changer the last couple of years. Sony is still marketing the PS2 along with the PS3, but what is noticeable is the growth of the Wii. Out of the top ten titles published in 2009, five of them are Wii titles. Last year the sales in the industry looked like they might improve slowly, and by November and December, they just absolutely took off. This was partially due to price reduction and specifically, the price cut of the Wii at the end of September.

So what are some of the revenue sources that drive these kinds of sales and this kind of growth? There are three broad categories with a lot of ancillary revenue sources. First off are the console manufacturers and the handheld device manufacturers. They get a licensing fee every time somebody makes a game that talks to their machine. They license their tool development kits. They also sell the hardware, which is extremely profitable. Online game-related access and personal sales generate revenue. The second large, broad category is publishers. How do they make money? Obviously by selling packaged goods; selling advertising; selling subscription fees—for example the World of Warcraft model. Engaging in micro-transactions, selling people little things, personal goods, other things in the game that people pay for and they make money from. These last two items are going to be increasing as revenue sources: licensing data that comes out of game play and licensing game content for crossover entertainment purposes. We will be seeing more and more of that. Developers get paid for developing. Sometimes they get a percentage, sometimes they get a profit share, sometimes they get a royalty.

I think these numbers look terrific. If you are a developer, it is really hard to get investors to invest in your development. In the last six months, there have been sixty investors, seventy-five investments, and there has been a total of $1.65 billion of investment money going into the gaming industry. What you will see if you look at a comprehensive list of investments is that there is just not that much game content that is being invested in. It is platforms, tools, applications that have cross-game applicability. It is infrastructure. And a lot of advertising-related technologies as well.

Questions for the panel to consider:

When, if ever, will the venture capital community be more open to investing in game content in addition to game tools, platforms, and other infrastructure?

What does the explosive growth in free-to-play social games mean for the evolution of video game financing techniques?

What are the major ways developers will continue to drive down game development costs for the Wii and other console games?

How will new revenue sources be shared, and will they result in more games being made and sold?

Will film finance come to games?

MS. CHRIST: When, if ever, will the venture capital community be more open to investing in game content in addition to game tools, platforms, and other infrastructure?

MR. BOESKY: The games are released by publishers, but they are also made by development teams—sometimes internal and sometimes external. An external publisher is pretty much defined by their insolvency. So you have a work-for-hire contract that is always terminable for convenience. Most often there is a kill feature, sometimes there is not. A developer may take in $10-20 million a year, but they also spend between $11-22 million a year. And it is not because they are poorly managed. Even the best-managed spend that money because publishers have leverage. So what happens when where a deal actually comes together is one of the largest inequities I have ever seen. You have a publisher with absolutely all the money—the developer is dependent on getting funded—and the publisher is constantly exerting leverage. The publisher may do it by trying to get the developer to change your choke without paying them extra money. They may do it by asking the developer to deliver things early. There are all kinds of things they do when they have that money leverage. And royalties are nice, but they are also very rarely paid at the end of the development of the game.

Developers go in and bid cost plus twenty percent, but they never get the twenty percent. They never make that twenty percent margin. They end up spending extra money to make the game better or the publisher forces them to spend the extra money. So developers and content creators have always been looking for new ways to fund the content and the IP that goes into the game. The market forces that drove the film industry to go to independent finance and private equity are all inflating the game industry. The difference we have in the game industry is that Hollywood understands the concept of mitigating the risk investment. The gaming industry, up until very recently, has never been willing to provide an equity participation in video games. There are numerous reasons for this, but to date that has not happened. And it puts the squeeze on content development. Publishers have just recently started to agree to give equity participation to developers. I have been talking to some publishers and private equity investors, and they are pretty excited about it. There are still some hurdles to get around. There are issues with timing—how long it takes to make a game, revenue realization, things like that. But I think that we are right on the verge of that type of money coming in.

On the technology side, even though we are software and technology companies, we are hit-driven companies. In the film industry, they call it launching an equity. If I make Avatar, and it generates a billion dollars at the box office, half of it goes to me, and that billion dollars also defines my downstream revenue. It defines all of my windows in the future. We call it an equity because it is a twenty year property when they market it. In the game business, I used to have sixty days, now I have forty-five days, if I am lucky, to make it at retail. In other territories, in Japan, for example, I may

only have two days. And if my product does not make it, it is off the shelf, and it has no value at all. The other thing that keeps the venture capitalists away, is that if my game comes out and it is bad, my bad game is a bad game. If I build a piece of technology and that technology does not work, I can leverage it into another industry. That is what makes technology so appealing to venture-capitalist companies. In games it is extremely easy to spend $10 million and have nothing. It is extremely easy to spend $10 million and have a game that people do not want. And it is exceedingly rare to spend $10 million and have something. I feel that we are close to independent investments and we are as far as ever from venture capital.

I had a conversation with an equity investor and someone who got a publisher funded by it. It is kind of a bad thing. It is kind of a good thing. There is a company called Relativity that funds about seventy percent of the movies for Sony and Universal. Relativity has this Monte Carlo model, and they plug in a bunch of different factors relating to a film, thousands of factors. As long as it spits out a number that is higher than their parameter, they green-light the movie. Good or bad, they make the movie. All they have to have is a print to deliver. So I was talking to this guy about this fund and how funds can go into video games. And he said that the criteria for a film are very different from the criteria for a game publisher. As a game publisher, the most important tool we had went away when publishers had to include $20 million releases into their forecasts. In film we have development. We make a script, and if the script is bad, you do not make the movie you never go into production. In games, you staff up to fifty people on day one, and you build. When games used to cost $1 million and return $200 million, your development was your first title release, and if it worked, you released more. We do not do that anymore.

When I was talking about this ability to kill, he said, you know, it really does not matter to a fund. To a game publisher, a game has to perform because of its quarterly earnings. To a fund, we just have to get approval based on the IP at the beginning. And the prospect of the team that is coming together—because the publisher does not assign teams coming together. The publisher only signs proven teams—and the fund says, "As long as we sign-off on all of that, we just care that there is a game. As long as there is a box, I do not care if it is good."

And Relativity said the same thing when they were interviewed. You know, "We are not there and do not judge quality," and, you know, it is kind of scary. So anyway, to a fund, yes, a fund would do it as long as the right elements line up to make it through a model because they have a different objective than a publisher who's accountable for quarterly earnings. And, again, this is all kind of nascent, and it is all of shaking out, but we've see it happen in other industries.

MR. MARQUEZ: So from a venture perspective, the question always gets asked, "Why do venture capitals not put money in the gaming industry?" If you think about venture sort of as an asset class or as a business model for us, I mean, it already has a high data to it. It is basically a portfolio theory.

You are trying to assemble a good assortment of technology investments—maybe one or two of them will hit and the majority of them will not. But when you think about that layered on top of gaming, I do not think venture capitals have a good sense for what games will and will not be good games. So the hit-driven-business comment—that's generally probably one of the reasons why venture capitals do not go through.

However, look at the data—the sixty new venture capitals. If you go back and trend that just four or five years, there are guys like Avista Partners and a couple other companies that have trends with a lot of the dates, and it certainly has increased. And go back a couple of years: probably about half of that. Intel Capital has been investing in the gaming space for years and for various reasons dating back to Jam Data and the mobile site and a couple other companies. But that being said, for when you're looking at just the trend charts of venture capitals coming into the gaming space, my perspective was that I thought it peaked out in around 2008 because I think it was around the same number. Looking at it that way, it was more along the lines of kind of watching the trends and whether or not Zyngas at that time were getting funded. So they were looking ahead of the curve a little bit. But going back to the question, are they investing in sort of the infrastructure or IP? At the end of the day, you are investing in games. Right? There is no real technology there. It is a bunch of simple games for a couple hundred thousand dollars. But at least the benefit they had was on distribution—they do not have to worry about going through the particular channels.

MR. BOESKY: They were investing in community. They were backing the guy who had success in booming communities and had a new way to build communities. So I think it is kind of like investing in eBay. You're not really investing in technology. There is nothing proprietary about the technology, but you're investing in the ability to build a community.

MS. CHRIST: But they didn't know how wildly successful they had been when they made their first rounds, at least.

MR. BOESKY: Oh, no, nobody did. And I think that it is kind of the same way, and what you're saying is just that in an individual game or a content itself, there is no exit.

MR. MARQUEZ: Right.

MR. BOESKY: I think the biggest difference between Zynga and other companies, when you look at investment—an investment in Intel isn't part of the herd. You get kind of backed on your own. But there is a herd that goes through, and we had the herd investing in MMOs.

MR. MARQUEZ: Right.

MR. BOESKY: And then we had a herd that went into micro-transaciton games.—

MR. MARQUEZ: Absolutely.

MR. MARQUEZ: It was a herd that went into advertising and game.

MR. BOESKY: Exactly. And I think that Zynga was the leader in that kind of pack. But again, the thing that really defined everything, aside from

leverageable technologies, is an opportunity for exit. There is no exit opportunity for developers.

MS. CHRIST: I am struggling with that. Please share—drill down a little bit. When you say no exit opportunity in games versus movies, I mean, why can you not just stop a game if it does not look like it is doing well?

MR. BOESKY: Well, what a venture capital is looking for—and, again, Intel's criteria is different. A venture capital is looking for a ten-times return in three-to-five years. So they are looking for of an exit opportunity of an IPO or a sale. Selling a developer is literally like hitting the lottery. There is no way to value one. I have sold developers before, and the only way to valuate a developer is to looking for comps. Comps are all over the place, and if I wanted to pick a comp when I sold a developer, I would pick Biodemic, Bioware and Pandemic, which sold for $800 million. And before that I would pick Rare, which sold for $400 million. And you never talk about the one who just exchanged all your equity for the royalties that the publisher owes them, which they were never going to pay anyway, because they are stringing them along. So there is really no sale for a developer.

MS. CHRIST: Is it conceivable, though, that you could form a fund, a slate and use that as a public vehicle—is that not something that really works?

MR. BOESKY: That is one of the options that we're exploring right now. And like I said, there are—there are accounting reasons. Accounting is changing. The biggest impediment is the time period that it takes to make a game. If you notice, there aren't a lot of private equity firms that have invested in animated features.

MS. CHRIST: Yes.

MR. BOESKY: As a matter of fact, there are none. So spreading out across the years is an issue that we have to get through, and then a return to the funds to make the IRR work. Putting a slate together is moving in the right direction.

The other thing is finding the distribution to absorb the volume that you need to raise the money for the fund. There are thousands of movies made every year and there are hundreds of games released. In terms of the numbers of games that are fundable, most publishers are cutting their slates back significantly. There are big publishers that are saying they will only initiate one or two major games a year. And the biggest one is doing maybe half a dozen.

MS. CHRIST: It is interesting, neither of you said anything about this, so I have to just ask you. And Keith, you and I have talked about this pretty extensively.

I had just assumed that outside investments are not there because there is not a vibrant completion bond industry, although I know there is an industry. It seems to me it is unproven as to whether or not those completion bonds are truly going to do what you think they are going to do.

MR. BOESKY: I would agree, the bonds do not work. It has been proven that they do not work.

MS. CHRIST: And the reason they do not work in games is because if you have got a movie and you have a director and a script and a screenplay—an underlining literary property by Robert Ludlum or something like that—you can take that. You can take it to a production company that is a bonding company as engaged and have that movie made and finished. Whereas a game, what are you going to do if the developer flakes? There is really no vibrant third-party production company, no mercenary business out there that completion bond companies can go to to get games finished.

MR. BOESKY: But I do not think you do.

MS. CHRIST: Is that an oversimplification or is it just wrong?

MR. BOESKY: No, I have been friendly with the biggest bonding company in Hollywood. They told me they were getting into this business in 1995 and asked my advice and I said, "Do not do it." And they have called me back from time to time with games come back to them and they have been in and they have been out. And when a new guy invested in the company came to me and said, you know, "Let's do this." He was explaining it to me, and I just was not getting it. And he just said, "All we have to do is — bonding is simple—we identify the risk and we insure against it." Oh, okay. Now I got it.

And that's the problem. In games, you cannot identify the risk. With a movie — the way a bonded movie works, like Roxanne said,—you give the movie to the director. The bond company, as per the contract, says, "I am going to deliver you ninety minutes of movie on this date." And if the director goes nutty, if something bad happens, they can pick up the movie and they can finish it, and you can always deliver ninety minutes of a movie on a date.

If you say, "I am going to deliver you six hours of game play, on a certain date, you can get really, really close to that date and have nothing. And I can bring another director onto a movie set. I can take film away from everybody and put it in front of an editor. There are situations where you just cannot—even determine with an infinite amount of money—try to pick up a game from a developer and finish it because everybody builds games differently.

And then we started talking today about outsource game development and you have got code that is common to the Bulgarian and Chinese, but not in other markets. I would argue that it is impossible to bond a game. And the only situations where I've seen bonded development work are where the developer develops all the way through. Unfortunately, publishers use the bonds when they're afraid that the developers will not.

I have seen them blow up in more cases than not. And the other thing is that it is really, really expensive. In film they charge three against five. They charge you five percent and they rebate two if your film comes in. In games they do not rebate the two. So now I am paying five points on my money that I am paying ten points on to use, and I am fifteen points in the hole on the game on a budget that was already stretched with a developer that I might not want to work with anyway. So the analysis is always: "Okay.

Now I just ran the financials. Well, if I really want to make this game, I am just going to pay for it myself. If I am going to make the bonded game and I am relying on the bond because I do not want to make the game I am not going do the deal." The reason the bonding companies get hurt, is there will be a publisher who says, "I would never sign with this developer because they have a track record of not delivering on time. But when they do deliver, it is interesting and they go over budget. So I'll let the bond worry about that and sign the game anyway." And you know, we have got a couple situations going on right now where the bond is covering.