

Sony Corporation and the Video Game Console Market: A Competitive Analysis¹

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¹ This report evaluates Sony Corporation's strategy in the console gaming market from the top-down perspective of the entire corporation.

Executive Summary

Sony's current strategy in the video game console market is simple: use the technologically superior Playstation 3 as a loss leader to introduce the Blu-ray optical drive² into consumers' homes and leverage that market penetration to drive content sales once Blu-ray is established as the *de facto* standard for optical storage. It is therefore in Sony's interest to reach the tipping point for market adoption of Blu-ray as soon as possible. To increase the rate of Blu-ray adoption in the market, we recommend that Sony adopt a "good-better-best" strategy, whereby Sony produces discounted and premium versions of the current Playstation 3 for sale to consumers. This strategy will encourage price-sensitive customers to purchase Playstation 3 consoles without marginalizing power gamers. Nintendo and Microsoft will most likely respond to this strategy with differentiation rather than price competition. If Sony reinforces this strategy with coherent marketing and intellectual property strategies, it can increase Blu-ray adoption rates and make it more likely that the format will be adopted as a standard.

The Market for Video Game Consoles is Growing, but Competition is Fierce

The market for interactive video entertainment is growing; this market grew four percent over the same period two years ago.³ However, all players in the market are facing increased competitive pressures. Substitutes for console gaming are growing rapidly (such as massive multiplayer online games, as shown in Figure 1), and as the first generation of console players reach maturity, many players will shift to these substitutes, a problem known as gamer drift.

The three main competitors are Nintendo, Sony, and Microsoft. The three are fairly dichotomous, either innovative and user friendly or technologically pushing the envelope. Nintendo has made its mission to do the first.⁴ Sony and Microsoft both fall in to the latter category. Thus, safe in a fairly differentiated position, Nintendo is in a dominant position in the marketplace. It has the expertise and reputation to not only maintain its position, but push out would be competitors. This has paid off and Nintendo sales of the Wii are far outpacing original expectations. Sony is no longer dominating the market, and compared to the previous distribution of demand for gaming consoles is losing significant ground. In terms of market share, Microsoft has stayed in about the same position as the previous generation of consoles. (See Figure 2.)

The consumer market is segmented mainly by age. The casual gamer, consumers who do not treat gaming as their main source of entertainment, represents 36 percent of the market.⁵ This

² A Blu-ray optical drive plays high density Blu-ray disks up to ten times the capacity of current DVDs. For more information, please refer to the "Blu-ray Disc" entry on Wikipedia, available at <http://en.wikipedia.org/wiki/Blu-ray>.

³ "Annual US Video Game Sales," The NPD Group, http://retailindustry.about.com/od/seg_toys/a/bl_npd012703.htm

⁴ "The development of games that are more complex and graphically intense has been the focus of game companies for too long. . . . Nintendo has implemented a strategy, which encourages people around the world to play video games regardless of their age, gender or cultural background. Our goal is to expand the gaming population." – Satoru Iwata, Nintendo President & CEO, in Nintendo's 2006 Annual Report

⁵ "Annual US Video Game Sales," The NPD Group, http://retailindustry.about.com/od/seg_toys/a/bl_npd012703.htm

group tends to be between the age of 18 and 24 and white.⁶ Nintendo is aggressively courting non-traditional gaming groups outside this traditional profile in an attempt to increase the size of the console market. In contrast, Sony and Microsoft court the “hardcore” gamer and expect console sales to trickle down to more casual gamers. These companies focus on serving their existing customer base, a group that views gaming as their primary source of entertainment. This “hardcore” group, which represents 11 percents of the market⁷, is more likely to play competitively and tend to buy more games and spend more time playing games than casual gamers.

This divergence of strategies is perhaps best illustrated by the marketing strategies of each company. Whereas Nintendo’s advertising consists of smiling, racially diverse groups waving around the Wiimote (wireless remote), Sony and Microsoft rely on less traditional means. Sony recently garnered much controversy over its Astroturf (fake grassroots) marketing strategies, including hiring spray painters to paint graffiti images of their consoles in urban city neighborhoods. Microsoft was also criticized for secretly giving influential bloggers free console systems in the hopes of getting favorable reviews.

As a result, Nintendo is viewed as a more wholesome, family-oriented company exclusively specializing in user-friendly gaming consoles and peripherals. Sony is viewed in somewhat more friendly terms than Microsoft and is the undisputed leader in terms of product quality. As a result of the name recognition and the cost of cutting-edge technology, Sony often charges a premium on its products. Microsoft, the most recent entrant into the market, tends to engender strongly divergent viewpoints. Some gamers view the product as an inferior version of Sony’s Playstation consoles, whereas others view it as one of comparable quality in its own right.

Sony is the undisputed leader in graphics and computing. The PS3 has a 3.2GHz processor, NVIDIA-SCEI GPU, Blu-Ray, and a 20GB hard drive⁸, compared with a 3.2GHz processor, 500MHz GPU, DVD drive, and a 20GB hard drive for the Xbox 360⁹ and a Broadway processor, ATI GPU, 2GB hard drive, and Wii optical disk for the Wii¹⁰. However, the other consoles offer value in different ways. Although it doesn’t have support for high-definition televisions, the Wii is the most innovative in game-play control and usability. The Xbox 360 excels as a gateway to online content. Xbox 360 Live has over 2 million subscribers as of July 2005¹¹, largely due to synergies between the home entertainment and online content divisions. Sony really fails to impress in either of these two dimensions. (See Figure 3.)

Because the video game console market is sufficiently saturated, there are no realistic possible entrants, except in related markets such as portable gaming. There are many formidable barriers to entry. With the intense price competition, large economies of scale involved, and entrenched companies spanning the Hotelling line of quality versus price, entering the market would most

⁶ Joe Pilotta, “Prime Time for Video Games,” 1/9/2006. <http://www.imediaconnection.com/content/7745.asp>

⁷ “Survey Reveals U.S. Gamer Market is Divesifying,” Parks Associates Identifies Six Distinct Groups, Based on Time Spent, Motivation, 8/29/2006, http://www.parksassociates.com/press/press_releases/2006/gaming_pr4.html

⁸ “PlayStation: PS3 News,” 5/17/2005, <http://www.computerandvideogames.com/article.php?id=118783>

⁹ “Xbox specs revealed,” CNET News.com staff, 5/12/2005 http://news.com.com/Xbox+specs+revealed/2100-1043_3-5705372.html

¹⁰ “The Nintendo wii Technical specifications list,” http://www.wiil33t.com/wii_spec_list.html

¹¹ “Xbox,” Wikipedia, <http://en.wikipedia.org/wiki/Xbox>

likely not produce a favorable return on investment. A potential entrant would need to have experience with video games and consumer electronics, significant access to capital, and significant name recognition or a marketing campaign sufficient to earn such recognition. Computer game producer Blizzard Entertainment or high-end consumer electronics designers Apple Inc. may have the resources and experience necessary to enter the market,¹² but it is also important to note that Sega dropped out of the market as Microsoft entered. This implies a market equilibrium of at most 3 firms, so any entrants would have to displace an existing firm. This is a daunting proposition, considering that Sony, Microsoft, and Nintendo have US\$6.06 billion, US\$34.2 billion and US\$6.58 billion respectively in cash reserves¹³ and can afford to (and oftentimes do) sustain continued losses for several years following a console launch.

Sony's Current Strategy Relies on Making Blu-ray the Standard for Optical Storage

Sony's current strategy uses the Playstation 3 (PS3) as a vehicle to introduce the Blu-ray standard into the home. The launch of the game console is particularly important for the Game Business, Entertainment Business, and Consumer Products groups, because all three groups have a significant vested interest in getting consumers to adopt Blu-ray technology. Sony's gaming business wants the Blu-ray because it allows developers to produce and consumers to enjoy games with unsurpassed picture and sound quality, stimulating new console sales. Sony's content division wants the Blu-ray as the new high-definition standard to drive sales in its music and movie properties. Finally, Sony's consumer electronics business wants the Blu-ray as the basis for selling complementary electronic devices such as high-definition televisions (HDTVs).

In contrast, rival firm Nintendo has shifted its focus to introducing new gamers to the home console market and integrating those consumers with its portable gaming division. Nintendo essentially sidesteps the problem of switching costs by currying favor with new gamers, which it does so with an innovative user interface and family-style games in the form of the Wii console. Microsoft, on the other hand, is responding to Sony's strategy by aiming for differentiation. Instead of contesting Sony's technological superiority, they aimed for a more rapid console launch to attempt to achieve a critical mass using their first mover advantage. In the long term, Microsoft seeks to leverage its superior software capabilities to build an integrated network of Xbox 360 consoles, through which it can deliver targeted advertising and online content to the consumer.

Video game consoles are different from other types of consumer electronics in that initial sales are made at a loss. This is an important first step that gets the consumer to purchase the console. Once a consumer does so, they are effectively "locked in" to purchasing new games solely for that console. This razor-and-blade strategy allows Sony to generate consistent, sustained revenue once a large enough user base purchases the console.

¹² "Apple Entering Video Games Console Market? Not Likely." Aaron Wright, 12/6/2006, <http://www.applematters.com/index.php/section/comments/apple-entering-video-games-console-market-not-likely/>

¹³ Sony Annual Reports, Financial Highlights <http://www.sony.net/SonyInfo/IR/financial/ar/2006/qfhh7c00000aksn4-att/qfhh7c00000aksoh.pdf>

Microsoft Annual Report, Financial Highlights http://www.microsoft.com/msft/reports/ar06/staticversion/10k_fh_fin.html

Microsoft Annual Report, Financial Highlights http://www.microsoft.com/msft/reports/ar06/staticversion/10k_fh_fin.html

There are several methods that Sony uses to compete for customers. First, it uses its name recognition to try and lock in its customer base by providing a console-specific gaming experience for the consumer. It usually offers an exclusive “killer app” game such as Final Fantasy that can only be played on their console and further incentivizes users to purchase the console by offering backwards-compatibility. Although most users are forward-looking, this allows consumers to retain the value of old Sony products and lowers the depreciation of current game purchases in the future. As a result, consumers will be more likely to buy more games and retain them for longer periods of time. This also reduces the size of the secondary game market because consumers will be less inclined to resell used games and game consoles. This strategy increases the cost of switching to non-Sony consoles for the sizeable base of existing customers.

Games for the PS3 are mostly made by third-party developers. Sony incentivizes third-party game production with the promise of a large, sustained user base and a technologically superior console. Developers can differentiate themselves from the competition by producing more visually appealing games on the PS3. The higher development costs are justified by Sony’s implicit guarantee that developers will be able to recoup their investment from their larger user base.

Sony also offers a few complimentary goods with its PS3. Because the Wii does not support HDTVs, purchasers of Sony or Microsoft’s consoles will gain additional value from the purchase of high-end HDTVs and other electronic accessories, which Sony also manufactures. Also, the ability of the PS3 to connect with the Playstation Portable (PSP) makes that a valuable complement. The PSP serves as a mobile platform that PS3 games can be ported to. As a result, owning both machines gives the consumer significantly more value. Finally, the ability of the PS3 to run third-party software and serve as a networking gateway increases the value of other consumer electronics, mainly due to network externalities.

Sony’s ultimate goal is to ensure that Blu-ray is adopted as the standard digital encoding format within the life cycle of the PS3, which Sony can then profit off of over the lifetime of the format. This strategy is very powerful, but it relies on three main assumptions:

- 1) Consumers will not be daunted by the price barrier that the PS3 poses and will buy it.
- 2) Sony has the production capabilities to meet market demand.
- 3) The life cycle of the PS3 is rapid enough to establish Blu-ray as the dominant format.

We examine each of these assumptions in turn.

Price Is a Significant Barrier to PS3 Console Adoption

The assumption that consumers are not put off by the price of the PS3 is incorrect. With the advent of next generation console, Xbox 360, analysts familiar with the industry has been continuously surprised by the strength of PS2 sales, which even today consistently outsells the Xbox 360. Two PS2 titles have even made the 3rd and 6th place of the bestseller’s list.¹⁴

¹⁴ “Wii Outsells Xbox, PS3 in January”,
http://www.betanews.com/article/NPD_Wii_Outseils_Xbox_PS3_in_January/1172093755

The PS 2 currently retails for US\$129, significantly less than the Xbox 360's \$399.99 price tag. From this data, we can tell that significant numbers of consumers want to play on a low-cost console with a rich portfolio of games, but are price-sensitive enough to avoid next-generation console systems. It is imperative that Sony convert these PS2 sales into PS3 sales to cut into Microsoft's lead and facilitate Blu-ray adoption.

Recent poll data suggest that more than 60% of Sony's target demographic think that the price of a PS3 is too high.¹⁵ To address this price barrier, Sony needs an alternative strategy that induces hesitant, price-sensitive gamers to switch from the PS2 to the PS3.

Sony Needs to Ramp Up Production Capabilities to Meet Market Demand

Sony out-sources the assembly of the PS3 to a Taiwanese firm called ASUSTek. The limiting factor in ramping up production has been the supply of blue laser diodes used in the Blu-ray drive.¹⁶ Limited supplies of this prevented it from reaching the 2 million sales target during its launch window; Sony currently it produces approximately 1 million consoles a month¹⁷. Sony has slightly more purchasing power than Microsoft, because of the sheer purchasing volume across its entire consumer electronics division. Nintendo does not have as much purchasing power, but this factor does not matter as much because they use lower cost components. Buyers, in contrast, have almost no bargaining power. However, price competition between the major suppliers tends to keep prices discounted from the actual cost for consumers.

The limited supply of blue laser diodes was particularly troublesome during the launch of the PS3. Since Sony's goal is to get the Blu-ray adopted as a market standard, the limited supply during the important Christmas shopping season in North America severely limited the impact of its initial launch buzz. Sony needs to ramp up production capabilities and place redundancies in their distribution chain to avoid supply shock, even if this increases sunk costs. Since it does not want to get stuck with a next-generation Betamax, Sony needs to ensure that it has the production capabilities to meet increased market demand.

Adoption Rates of the PS3 Are Not Fast Enough to Establish Blu-Ray as the Dominant Format

By waiting to incorporate Blu-ray technology into the PS3, Sony essentially gave Microsoft a one year lead in the current round of console sales. It is estimated that Microsoft has sold over 10.6 million consoles, while Sony has sold only 1.5 million units.¹⁸ This comes out to a comparable adoption rate for both systems, far from the estimated 2/3 market share needed to win a format war. (We assume that Xbox 360 owners will skew towards the rival HD DVD format because of Microsoft's support of it.) Neither format has yet to reach the tipping point for market dominance, so it is clear that Sony must increase the adoption rate of the Blu-ray drive.

¹⁵ "What do you think of the PS3 price?"; <http://slashdot.org/pollBooth.pl?qid=1353&aid=-1>

¹⁶ "Sharp: We're upping Blue laser diode production," Tim Y. 12/20/2006, <http://ps3.gj.net/Sharp-We-re-upping-Blue-laser-diode-production/pg/49/aid/76783>

¹⁷ "Sony PlayStation 3 Production Has Begun – Reports. Asustek Computer Ships PlayStation 3 Consoles," Anton Shilov, 7/18/2006, <http://www.xbitlabs.com/news/multimedia/display/20060718235111.html>

¹⁸ "Nexgen Wars" <http://nexgenwars.com/>

Sony Can Increase Market Share by Improving Product Usability

Sony has a history of making technologically superior products that blow up in their own faces due to a lack of usability.¹⁹ It is important to recognize that this perfectionist mentality originates from an engineering culture and that better technology does not necessarily translate into customer satisfaction. Sony is effectively conceding the console gaming market beyond Sony's existing customer base if it fails to impress their customers in all aspects of design. One obvious omission is the lack of a rumble feature to the PS3 controller to immerse players in games they are playing.

There are two aspects of partnership that Sony should pursue: hardware and software. On the hardware front, Sony needs to accelerate the life cycle of its PS3 console. Sony should aggressively seek out new partners to produce more Blu-ray drives and PS3 units to cut into Microsoft's one year launch lead. Not only does this reduce the price of a major component of the PS3, this increases the likelihood that Blu-ray will be adopted as a standard. Although this may reduce the barrier to entry for those firms, it is currently much more important for Sony to accelerate Blu-ray's development than it is to worry about new entrants, which is a small, long term concern.

On the software front, Sony can align their interests with that of game developers by setting up a profit scheme in which developers get a higher percentage of profits from game sales as console sales increase. This is a high-risk, high-return strategy that aligns the interest of both Sony and developers so that both have a vested interest in ensuring that console sales are large. It is also important to work with developers and perhaps even devoted fans to create the software architecture necessary to produce games more easily. By encouraging developers to share tools with fans, Sony can generate more content for its system, which directly influences console sales.

Sony Should Work to Transform Substitutes into Complements

Another area of partnership that Sony should more aggressively pursue is the online gaming community. Integrating online computer gaming with online console gaming is a synergistic move that benefits both groups: the online game providers gain more users (and possibly a massively parallel hardware system to run their games on) and the PS3 gains more market penetration. This also invests more users in the product and transforms a former substitute into a complement. The increased user base can also be something which Sony can leverage to induce more developers to make games exclusively for the PS3.

In the long term, Sony can also court other non-traditional sources of content. A large, networked console system allows targeted advertising and delivery of movies, PC games, photo-sharing, online dating, videos, and other user-created content. Allowing users to shape the content of the machine (using other Sony products, of course) further invests them in the Sony brand, adding the significant new element of network externalities and synergy effects to the switching cost factor of consoles. Sony should focus its research and development (~8% of sales) towards developing in-house expertise pertaining to usability and networked gaming.

¹⁹ Sometimes this happens quite literally, as in the case of their batteries.

Finally, Sony should leverage its market penetration with its mobile gaming platform, the PSP. Content should be made interchangeable between the two, and the ability to access one from the other should be flawless. The ability to record video clips of their own games (high scores, bosses, etc.) and save games and share those with friends across consoles is a very important usability feature that Sony needs. Sony needs to talk with its fan base to learn how best to reward achievements that its customers accomplish.

Sony Can Significantly Increase Market Share by Pursuing a “Good-Better-Best” Strategy

Most importantly, however, Sony can significantly increase its market share by pursuing price-sensitive gamers. Instead of trying to stimulate PS3 sales by accepting a larger loss on the consoles themselves, either directly by lowering prices or indirectly by bundling old PS2 games with the new system, Sony should also offer stripped down and premium versions of its console systems. A \$299, \$449, \$799 “good-better-best” strategy with consoles that vary in hard drive space, memory, and processing power would increase sales to price-sensitive gamers without marginalizing trendsetting “hardcore” gamers.

To promote the Blu-ray standard, Sony should sell Blu-rays in all console versions, but keep the lower-end versions to read-only instead of read-write to keep costs down. This does not significantly increase production costs, since the PS3 is assembled using standardized parts. Then, as production costs decrease and market penetration increases, the lower-end versions can be gradually phased out and supplanted with better versions. Vanity customization (such as different colors) should also be encouraged as a cost-effective mean of providing more value to consumers. (This is similar to Apple’s strategy of creating five successively newer and better generations of iPods.) We offer a breakdown of costs for the “good-better-best” consoles below to show that Sony can scale costs and adopt the strategy without incurring significantly more losses.

	Good	Better (current version)	Best
Processor	\$100	\$190	\$400
Disc Drive	\$100	\$250	\$350
Graphics Chip	\$100	\$140	\$200
Memory	\$40	\$65	\$100
Hard Drive	\$20	\$40	\$100
Other Doodads	\$130	\$130	\$130
Total Manufacturing Cost	\$490	\$815	\$1,280
Retail Price (at 40% discount)	\$294	\$489	\$768

Another way Sony can reduce consumer costs without significantly impacting future revenue is to offer credits towards online game or music purchases in exchange for old PS2 consoles. Not only does this reduce the secondary sales market for the PS2, which cuts into Sony’s PS3 sales, this rewards customer loyalty while lowering consumer costs. Even if Microsoft adopts a similar strategy, this effect is largely contained within each company’s established gamer base. As a result, Sony can sell significantly more PS3 consoles and therefore, increase the market share of the Blu-ray drive.

The “Good-Better-Best” Strategy is Extremely Cost Effective

A cost-benefit analysis of the “good-better-best” strategy shows that it is extremely cost effective. A high-end estimate of the total cost to Sony’s Game division from our “good-better-best” strategy is US\$2.62 billion. From our analysis, this is equivalent to approximately 557 million game sales, a value comparable to previous PS2 game sales figures. Since this ignores revenue Sony accrues from console sales and synergistic effects across Sony departments, the creation of a Blu-ray standard would be worth significantly more than the costs of our “good-better-best” strategy. It is also important to note that this value is not much different from the loss leader strategy Sony is currently employing, since the margins on our cheaper version are the same as those for the current version.

Our analysis assumes that for Blu-ray to become a standard, Sony and its partners must capture at least 2/3 of the market in the early stage of the life cycle. Since Sony has been using the PS3 to accelerate the adoption, and Nintendo will not use the next generation optical drive until a clear winner emerges, the game division within Sony needs only capture 2/3 of the console market for non-casual gamers, which largely excludes Nintendo.

As of December 2006, 171.48 million units of previous generation game consoles have been sold. Since the start of this product cycle, two major factors have been affecting the growth of the game console market. A boom from emerging countries has been outweighing gamer drift, causing the game console market at a slow but steady rate. Our rough estimate is the Xbox and the PS3 will share a market roughly the size of the previous one (171.48 million) and the Wii, which has branded itself as family-centric, will go after new gamers who haven’t been previously courted.

Our key assumptions are:

- 1) Sony needs to grab 2/3 of the 171.48-million-unit market, which is approximately 111.46 million units over a life cycle of six years. For our conservative estimate of profits, we assume that sales figures are constant over time.
- 2) The estimated cost of PS3 is US\$815, but it currently retails at US\$499; the console sells at a discount of 38.6%. Sony loses approximately US\$96 for every Blu-ray drive that comes with the console.
- 3) Increasing adoption of Blu-ray and improved throughput will reduce the loss from the drive exponentially, from around \$96 per drive now to break-even in 5 years. We base this assumption from historical data of DVD player prices: historically, the average price of DVD players’ has followed a sharp downward trend, from \$350 a piece in 1999 (5% of market share) to \$20 today (universal adoption).

Year	2007	2008	2009	2010	2011	2012
Loss per optical drive (US\$)	96.6	30.6	9.7	3.1	1.0	0.0
Consoles sold (million)	18.6	18.6	18.6	18.6	18.6	18.6
Yearly loss	1795.0	568.4	180.0	57.0	18.0	0.0
Aggregate loss over 6 years	2618.4		millions			

Cash reserve (2006 year end) 6063.8 millions

(Note: The current Japanese interest rate is low enough to neglect discounting)

From the data, we see that the cost of our strategy is about US\$2.62 billion. Since adoption is more likely to be greatest in the middle of the 6-year cycle, where the lost per optical drive is lower, it is fair to look at this value as an upper limit on aggregate loss. Conservatively estimating that Sony gets a US\$5 (roughly 10%) licensing fee for every PS3 game sold, with each console owner buying 5 titles, Sony is estimated to make (5 dollars/title) x (5 titles/console) x (111.46 millions of consoles) = US\$2.8 billion, which is enough to break even. This value should be viewed as a lower bound on profits, as this neglects the significant additional profits from console sales and the value of synergistic effects, mentioned elsewhere.

The “Good-Better-Best” Strategy Works Best When Supplemented with a Consistent Marketing and Intellectual Property Strategy

Sony traditionally relies on alpha consumers and brand recognition to generate initial sales. As a result, its advertising targets a small subset of “hardcore” gamers. Unfortunately, this “trickle-down” marketing strategy is at odds with its Blu-ray strategy, which seeks to maximize market penetration as fast as possible. Sony should coordinate its “good-better-best” strategy with its marketing so that there is more congruence between the two. We suggest that marketing strategies continue to emphasize the superior technological attributes of Sony consoles for “hardcore” gamers, but subtly shift the dialogue to the overall gaming experience for more casual, price-sensitive consumers. For these customers, Sony should promote the PS3 as an “all-purpose” gaming system and exploit related services such as web functionalities to entice gamers. Although there is the danger of brand dilution through this method, it is our belief that the large price differential between the different models is sufficient to provide consumers with the same value per unit price.

Sony should also explore the possibility of using its considerable number of game design patents as an intellectual property strategy.²⁰ As the “good-better-best” strategy still relies on games to drive sales, Sony needs to justify the higher game development costs for the three different consoles. In addition to tying console sales to developer profits, as we mentioned earlier, Sony might also use such patents as an additional carrot to give preferred developers a competitive edge over others. For example, it could offer environment sensing game technology only to exclusive developers, as another incentive for developers to produce games for Sony consoles. Although there is the potential for a public backlash against overly strict policies, this intellectual property strategy is usually a win-win relationship that benefits both Sony and its developers.

Nintendo and Microsoft Will Most Likely Respond to “Good-Better-Best” Through Differentiation, Not Price Competition

²⁰ For further discussion of patent strategy in the gaming industry, see <http://www.ipfrontline.com/depts/article.asp?id=8499>

The “good-better-best” model brings Sony into direct conflict with Microsoft and to a much lesser extent, Nintendo. Since the margins in the console gaming industry are already low, with Microsoft Home Entertainment Division operating at a loss, Sony Game Business Group Division operating at 4% and Nintendo operating at 18%, any kind of price competition would be lose-lose for all the firms involved. Since Nintendo is targeting the casual gamer market, there is relatively little overlap between its offerings and Sony’s, so it will be more inclined to compete on quality, relying on unique game offerings and their innovative user interface to penetrate further into the casual gaming market.

Microsoft is more likely to engage in the price war than Nintendo because its goal of market penetration is in direct conflict with Sony’s goals. However, it is important to note that Microsoft’s console gaming division is significantly less important to it than Sony’s. By pursuing a “good-better-best” strategy, Sony would be signaling to Microsoft that it will not back down from a price war, simply because it has too much to lose. As a result, Microsoft is more likely to pursue a similar strategy of quality competition, based on its software expertise. It is important, however, that Sony not push Microsoft completely out of the market. Not only does Microsoft keep other potential entrants out, it will likely enter into a ruinous price war if it feels it has nothing to lose.

Conclusion: Converting the Existing User Base is the Best Strategy for Sony

Our “good-better-best” strategy will keep losses in the video game console market on par with Sony’s current loss leader strategy in the short term, but will significantly increase revenue in the long term from Blu-ray licensing fees and product synergies. Based on our analysis, it is clear that the optimal strategy for Sony to promote Blu-ray adoption is to convert existing PS2 gamers to the PS3. This is most effectively done by creating incentives for price-sensitive PS2 purchasers to purchase PS3 consoles instead. This strategy is cost effective and we believe that many other complementary strategies can and should be implemented around this unifying strategy. We believe that, implemented properly, this strategy will put Sony firmly back on the track to long-term success in the video game console market and beyond.

Total MMOG Active Subscriptions

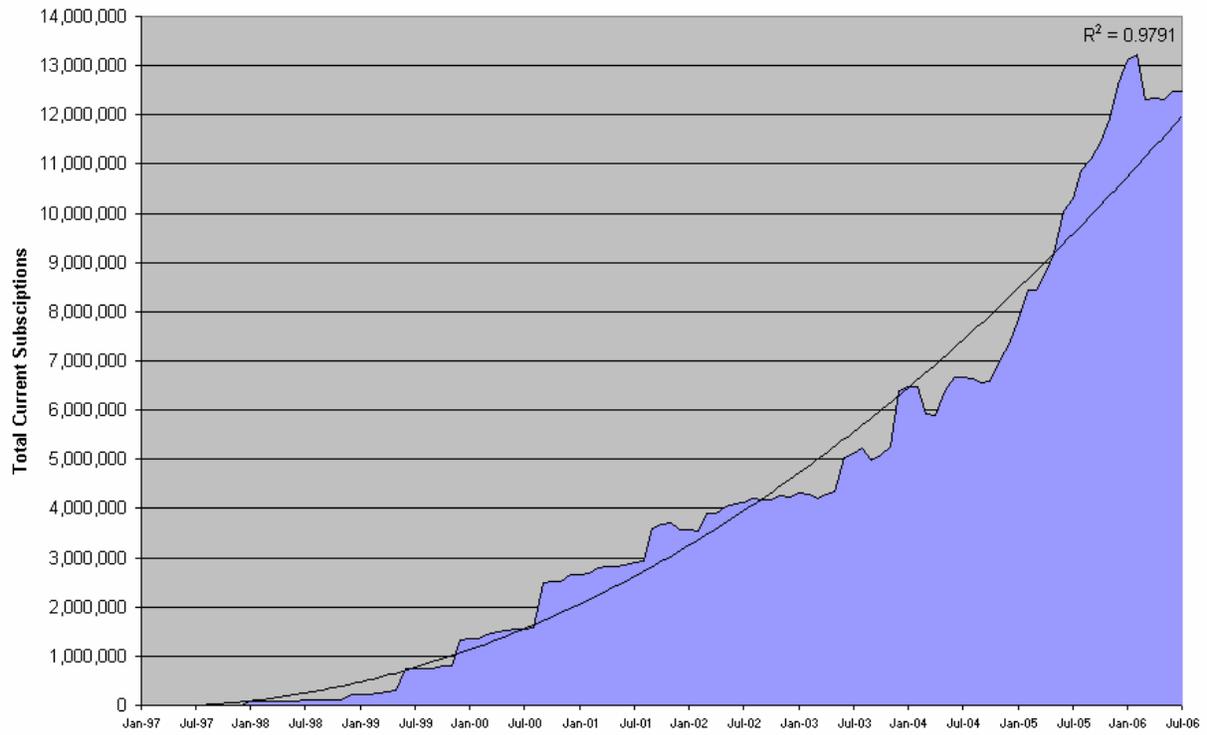


Figure 1. Massive Multiplayer Online Game (MMOG) Subscriptions as a function of time (<http://www.mmogchart.com/>)

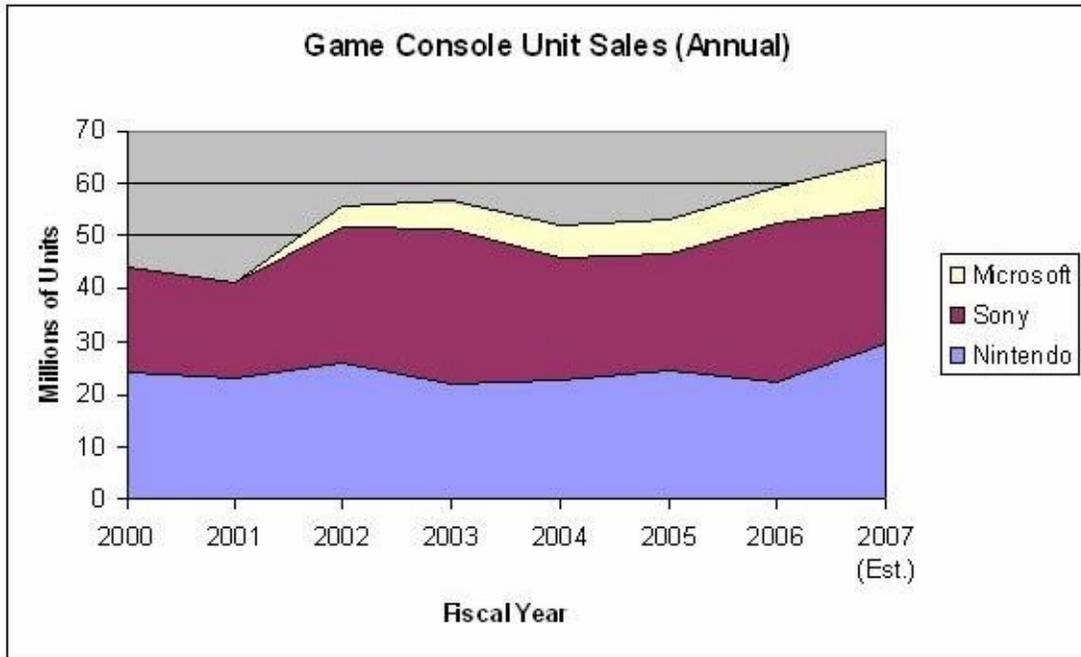


Figure 2. Sales of Consoles in Millions of Units over time
<http://ce.seekingalpha.com/article/22075>

SHOPPING THE PLAYSTATION'S ONLINE STORE IS FUN AND CONVENIENT.



Figure 3. Penny-Arcade Online comic (<http://www.penny-arcade.com/comic/2007/03/02>):

Penny-Arcade is often a voice of the hardcore gamer. In the past they have attacked certain policies and aspects of the gaming industry and seen real change due to their satire. It is definitely not advantageous to be under attack by their pen.

Share of Seventh Generation Game Console Market

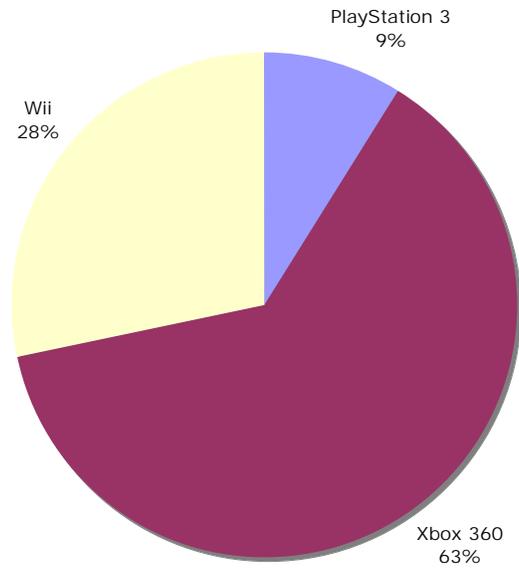


Figure 4. Share of Seventh Generation Game Console Market (Data from NextGen Wars)