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Panel: The Future of Digital Distribution

The Future of Digital Distribution

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MODERATOR:
Keith Boesky, Principal, Boesky & Co.

PANELISTS:
Paul Raines, Chief Operating Officer, GameStop Corp.

Christian Svensson, Vice President of Strategic Planning and Business Development, Capcom

MR. BOESKY: My name is Keith Boesky; I am in the game business, and I have been doing it a long time. I started out as a lawyer, and after about six years I made a career change. I ran a game publisher for a little bit, went off on my own, and spent a few years at a Hollywood agency. For the past six years I have been working on my own with a handful of IP owners and some game developers. Because it is January 27th, this morning we had the choice of either introducing you to the new Apple tablet and showing you all the features, or talking about the future of gaming: distribution. We thought you would be much more interested in the future of game distribution, so Apple kindly delayed their launch until this panel ends. And Mr. Jobs, we will not preempt.

Joseph asked me to do this panel today, and it is very relevant because our industry is changing, just like every other business. We are changing quickly, and people do not necessarily know where it is going. We had a little advantage in the past because our cycles happen on a regular, fixed basis, and the business repeats itself on a regular, fixed basis. If you have been in it long enough, it is kind of a lather, rinse, and repeat cycle. All of the sudden now, we got to the lather part, and we certainly got rinsed, but we do not know whether we should repeat or do something new—go straight to the conditioner or, just hang it up and let the new kids move in and do what it is that we used to do and what we thought we were doing.

So, in this environment, Joseph asked me to speak. He did not ask me to moderate, he asked me to speak. He said, "The conference is really good—good crowd, good conference—I would love to have you speak." I said, "Oh sure, Joseph! That sounds great—support the lawyers, speak at the conference. That is wonderful!" I got a Google Alert that came up for my name, which is slightly less narcissistic than Googling yourself every day. Not much less, but slightly. That is when I found out that Keith Boesky is moderating the panel of the future of digital distribution, which is great because I am just as clueless as everybody else. When you are clueless and everybody else is too, you can make things up. But then, I saw I was on the panel with Paul Raines and Christian Svensson. I said, "Okay, here are two people who are very significant—not only to the whole business, but narcissistically, to my business."

The first time I met Paul Raines is salient because I was speaking at a conference like this, and I have some distinct views about things like used games which I seldom keep to myself. I was on a panel, and the discussion ended in a rant of, "And that is why we have to kill GameStop." Somebody raised their hand afterwards, and said, "Hi, I'm from GameStop." It was not Paul, it was the General Counsel. He took me outside and said, "Let's talk." We spoke for about an hour, and he said, "Okay, let's agree to disagree, and I think you should meet our COO." He called me up afterwards and said, "Paul would love to talk to you." I asked, "Did he read my blog?" He replied, "Yeah." "Oh . . . Paul wants to talk to me." I did not think it was going to be pleasant.

Paul called me out to Texas, and I found out that he was a big guy—much bigger than me. That got me scared because I was a Jewish boy coming out from L.A. Sitting in a hotel room in Dallas on the morning of the meeting, I had this vision in my head of walking into a room with Paul polishing his shotgun and saying, "Nice to see you, boy. We are going to play a game we call Cowboys and Indians. You are the Indian. I will give you a five-minute head start." But he didn't do that, and we didn't play that game.

He was very, very kind and very receptive. We have had a great relationship—agreeing on many things and sometimes agreeing to disagree. We are fortunate to have GameStop here because as Paul just said, it is very important to GameStop to make sure that the industry grows. GameStop is a valuable part of our ecosystem. Right now, it is the company that touches the consumer more than we do. We are the content creator.

Christian Svensson is in a very interesting place. Not only are we going through a transition in the industry, but the Japanese publishers as a whole are going through a transition. In previous console cycles, they had an entire market that they were able to profit in and really look at us as "the cream," which some of them still call us. They were also leading the market in game innovation and we were buying all of those games. That is changing right now. As their market is getting smaller, it seems like they are looking more to the West and joining all of us for the first time to try to figure out what we are going to do to profit and this tells us that there is a reason for us to exist in a world of *Pocket God* and *Mafia Wars*. With that, I would love to have these guys introduce themselves, and then we will get into questions, and I will try not to humiliate myself or disrupt my business. Paul?

MR. RAINES: Thank you. Thanks for the invitation to be here today. I am the Chief Operating Officer at GameStop, and I have been there coming up on two years. I manage all of our merchandising market store operations, supply chain real estate, and our Canadian business. I get a pretty good view of our publishing community, a pretty good view of our customers, and of course, a very good view of our investors, which is always fun. The point I would make as we kick things off is that we at GameStop are committed to the category, and often we are perceived, as Keith said, as a business that is trying to get in all of the profit pools in the industry. What I will tell you is we are really focused on gaming and the consumer. Everything that is good for gaming and good for the consumer, we see as good for us. This industry has a lot of that activity, and we compete everyday with the largest retailers in the world who really are trying to kill us—not just jokingly, like Keith. When you are competing with Wal-Mart, Best Buy, Target, Karstadt in Germany, Media Mart, and FNAC in France, you are competing with the largest retailers in the world. The only way a company like ours survives is to be dedicated to the category and to understand the consumer better than anyone else.

MR. BOESKY: That little $9 billion company that you are.

MR. RAINES: That is our focus. One of our founders, Dick Fontaine, has a great saying about this. He says that at the end of the day, we would all agree on the inevitability of technology to advance and rule everything. It is pretty clear that there is a technology advance. What is not so clear, and where we have to spend our time, and where a lot of shareholder value resides, is understanding the chronology. There is such a thing as premature abandonment, and there is such a thing as consumer acceptance, and we find that they get underrepresented in discussions around the categories. Hopefully, we can talk about some of that today.

MR. SVENSSON: I am Christian Svensson, the Corporate Officer and Vice President of Strategic Planning and Business Development at Capcom. It is a long title that basically encompasses and touches a lot of things. There is pretty much no part of our business that I am not responsible for. Everything from portfolio planning to forecasting long-term strategic initiatives like our digital initiative—I manage all of our research, and all of our digital channel is run out of my little office. Our aggressiveness on the digital front is part of the reason why I have been asked to come here today. With that said, I also understand that we are in the very, very early days of where digital is going. I view digital within the company as an opportunity for Capcom to get a little bit of strategic advantage to understand how those channels work, how marketing changes what our digital consumer is looking for, and how to address that change in demand.

MR. BOESKY: Let's begin. Jay [Cohen, of Jerry Bruckheimer Games] went through and showed us what the software market looks like, and our sales are actually pretty consistent with where they have been every cycle, except our costs have gone up exponentially. I suppose the first part, starting with you, Christian, is that there is a lot of doom and gloom and a lot of red on most publisher's balance sheets, but what is working?

MR. SVENSSON: Unfortunately, the sacrifice at the altar of innovation—our sequels and franchises are working. I think where you see major misses, including at Capcom, is in sizeable, high-risk budget bets on new IP, especially at this point in the cycle. What consistently works is—if a game sold three, four, five, seven million dollars last year, the odds are that the next generation will not be too far above or below that.

I will take it a step further—what we are actually starting to see is increased price pressure and shorter durations of on-shelf time at full price. Price protection requests come in fast. Product life cycles are shortening, and that full price $10 benefit has worn off in the last year to 18 months.

MR. BOESKY: How about you, Paul? Have you seen any differences?

MR. RAINES: I think what is working—I would agree with Christian that strong franchise sequels have done well. We would say that 2009 was a good year for core games or new titles. Of course there is *Modern Warfare 2*, but there are several others that did extremely well for us. We tended to grow our share on those versus the discounters and the mass retailers. So we are happy with that. I would say that the discounting activity during the holiday season is a different phenomenon in the United States. We see it all over Europe and Canada, but it was the first time we really saw it as much. I think that is a real question for the category—if we follow the analog of movies and publishing, that will put a lot of pressure on the channel that was not there before. I do think that at the end of the day, knowledge of the consumer and giving video game consumers what they want when they want it will continue to be a strong strategy. The casual consumer came in very strong during the holiday season. We had record Wii sales in the United States, and I believe there was a huge seventy percent increase in December. Year after year, those titles rode along with that. Will that consumer be there when the holiday season is over? I am not sure. It was certainly not the case last year—so we have to wait and see. I think quality and consumer focus continues to be important. We also have a very interesting growth in our digital content that we sell, and we are doing some unique things around downloadable content sales at retail that we think will be productive, but by no means is that going to take on more than a single digit share of our business.

MR. BOESKY: When you are talking about focus and consumer awareness, are you addressing game features or marketing? Do you feel there is a difference going on in marketing that is driving sales in different marketing channels—is it broader now, or are there bigger budgets now?

MR. SVENSSON: I would say budgets are definitely getting bigger on the marketing side. As your product development bets go up, so do your marketing bets. Let's just talk about marketing—depending on who you are, your media spend is somewhere between eight to twelve percent, sometimes fifteen percent of what your forecasted net sales are. If you break even on a $30 or $40 million project, that is three or four million units. Your marketing budget is obviously significantly lower than what it was, say two or three years ago, where your budget might have been $15 to $20 million. As your break-evens go up and your forecasted units required for profit go up, so too do your marketing budgets.

MR. BOESKY: It has been this way as long as I have been in the game business—you project your marketing off your projected revenue. Your spending is based on your projected revenue. That means that if your forecast goes down, your marketing goes down. In Hollywood, if your forecast goes down, you are not tracking well; your marketing goes up because we have to tell people what is going on because this is our opportunity to establish the revenue on the downstream windows. So it kind of feels like you are getting to the goal line and punting. If you spend 30 million on a product, shouldn't you tell people?

MR. SVENSSON: Well, there is a challenge. There are two parts: there is generating awareness and then there is measuring interest. When you actually get to a certain point in a product's life cycle and you have tested and tested and tested—think of it as test screenings for a movie—we may test and test and test and figure out, what do we have with this product—is it what we had hoped it was going to be, or is it not quite there? Sometimes you do cut your losses. Sometimes you ask, "What if I throw in other $3 or $4 or $5 million onto the pile, is that money going to come back to me?" Not at this point, and you sort of back away. You do not send it out to die necessarily, but you do not overinvest. You do not increase marketing to offset a lack of interest in the title, provided your awareness levels are at an appropriate level. You have to have awareness for sure, but you also have to have interest and awareness.

MR. BOESKY: Does that marketing span have an influence on your orders, Paul, outside of MDS within the store? Or does MDS have an impact?

MR. RAINES: Our marketing spend is a big part, but I would say I think the pressure Christian is talking about is forcing this category to behave a little more like what some other categories have migrated to in the past few years. I think we have some developers in the room. What we see is a heavy focus on Metacritic scores for example, and a lot of publishers want to tell us about Metacritic, and it is the focus. I read it in all the quarterly updates from CEOs and publishers. What we see is that at sell-through, there is not a high correlation of Metacritic scores to sell through. If somebody calculated our squares, they would be very low.

MR. BOESKY: Could you repeat that to make sure the people tweeting got that? Get that out.

MR. RAINES: That does not mean quality is not important. But what I find is that, in terms of your marketing expenditures, you have to be more efficient than ever. One of the things we are spending a lot of time on is to understand consumers. Take for example, the *Tekken 6* launch—if we can go out and market to the consumer that bought the last three versions of the game plus the ones that bought *Street Fighter*, our ability to create redemption of mark downs and promotion is much more higher yielding than just running an electronic media ad on Saturday TV on ESPN. I think it is going to force us to be sharper when working with publishers choosing how marketing is done for consumers who have demonstrated a propensity for a particular franchise—even if it is new IP. If I can create some type of data mining that tells me, "consumers who like this game this game and this game will tend to consume IP of this type," that is going to be a productive marketing expenditure. We see that as a big future focusing on where the marketing expenditure goes if it goes down. If it goes up, we think there is a piece of marketing that has to focus on quality of the expenditure.

MR. BOESKY: In addition to marketing, I have been hearing varying commentary on the importance of downloadable content in terms of additional feature sets, additional maps, and other additional features for games. Some people think it is very critical. I have heard numbers like fifteen percent increase in sales attributable to download. Have you all seen that having an impact, and if you have, is there a relevant window or size, because you have to have a balance to make sure the consumer does not feel ripped off.

MR. SVENSSON: There is a lot of data we have on titles that we have done downloadable content (DLC) on and titles that we have actually not done DLC on and watched the corresponding sales curves of both. There are optimal times for different genres but generally the peak active, online-connected, user-base is usually somewhere between four and six weeks after launch. So having DLC or at least the first package of DLC available in that window is how you maximize sales for that type. Certain genres might be a little bit earlier, certain genres a little bit later, but four to six weeks is a good guideline. Moreover, if you have not planned the DLC into the production process, and you start the DLC as you finish the game, you probably will not be able to get content out in time. There are some other plays in which there are large pushes for GTA to have sizeable premium deals a year from post launch. We are doing the same thing in the next two weeks or so with *Resident Evil 5*, pushing some pretty big chunks for what we call our Gold Edition as well as a related retail component. A slightly riskier play, but I think we are cautiously optimistic that that is going to work out for everybody. Is that as good as having that content six weeks after launch? Probably not, but it was not ready, so it was not there. We have also seen DLC help keep it in consumers' hands longer, which helps reduce supply in used-product distribution channels. The very knowledge that that DLC is coming in some point in time helps that process, or at least slow down when secondary channels start kicking in and eating into other front line sales.

MR. BOESKY: Does that lead to more reorders?

MR. SVENSSON: Yes, that is our assertion. For titles that have had no DLC there are typically far fewer reorders than for those titles that have later DLC.

MR. BOESKY: And how do you support those reorders, Paul?

MR. RAINES: Well, DLC is good for the category. We back up and consider collector's editions and limited editions. Everybody has seen collector's editions come out, which cater to the game enthusiasts. We usually sell out of a collector's edition or a limited edition offered in stores. We typically sell our full allocation and though there are exceptions on games, if you are a *Batman* enthusiast, you want the game, you want the extra levels, you want the unique GameStop level, and if I could give you some alternate movie endings, you would buy those too. If my supply chain could absorb it, we would sell some hats and t-shirts to go with it. There are enthusiasts who like it, so from that point of view, downloadable content is a good thing because it enhances an extended game play, and that is good for the category. Now, the problem with it is, it is a very small business. I have heard fifteen, twenty, thirty percent growth at a lot of publishers, and that is great. The problem is, it is a very small-scale business, so it needs to be scaled up to become meaningful. There are a lot of hosting costs that are fixed costs and anchored costs that we need to scale up so that people can make more money on it. Our point of view is that the consumer has so much friction around downloadable content that the consumer adoption is slower than it could be. While there has been great growth on downloadable content, if you compare it to the 500 million visits we see in GameStop stores in a year, if we can just convert two percent of those people to downloadable content customers—it would make a dramatic impact for everyone in the channel. We would like to support it and be a part of it. I also think downloadable content is a profitability opportunity for a lot of publishers that will continue to grow, but the friction piece with consumers is the hard part, because we are the market-share leader on points cards, so we see a lot of those consumers. Consumers tell us, it is difficult to find the content that they are looking for—it is a crowded catalogue, so how do I make my title stand out? You may love the game, but you cannot find the content, or the right one. So, we think that there is a role for a game advisor to tell a customer, "Hey you know what? You love *Madden*? Where are you from, Philadelphia? How about the Donovan McNabb uniform pack? I will sell you the package product at retail. I carry the catalogue at digital, and I will go ahead and sell it to you; it will be downloaded to your gamer tag when you log on." That is what we would like to see in the channel, because it would be good for everyone. By the way, it will also grow the used business and allow publishers to participate in the used business. We have had some conversation with developers that say, "Here is my top used game from your franchise. If you could give me some unique downloadable content for $4.99, $6.99, $7.99, we will attach thirty percent of every sale. We will have a downloadable piece for you." We think that that extends game play and gives the enthusiast more action in the game. Right now, I am hung up on *Uncharted 2*. I finished the game, and I cannot get past how cool the graphics were. You could come to me and sell me ten more levels of *Uncharted 2*.

MR. BOESKY: I have heard that a lot. I was at a meeting the other day where we were talking about subscription, and this is where it is incumbent on us to make games that people actually care about. The one game that I recommend to non-gamers who want to learn about gaming is *Uncharted*. I know they can play it. A novice gamer cannot play *Assassins*, which is great, or *Call of Duty*, which is also great but where the player will get his head shot off.

MR. RAINES: In *Call of Duty*, five seconds after you respond you are dead again.

MR. BOESKY: Exactly, because the guys stand at the swamp point and team up against new players. But, with *Uncharted*, I have heard a lot of people say that novice players would sign up for subscriptions and downloads because they want to see the rest of that story. So, I think that there is a quality requirement to reach big markets. But Paul, there is friction which we discussed on the phone in preparation for today and which you just touched on. There are other industries that have completely lost their retail to digital. There is Apple commoditizing content, and other people following suit. There is Amazon addressing the book business and taking margins away from publishers in control of the consumer. So, it would seem that a similar transition is inevitable for our industry as well because we sell bits just like they do. But you have brought up this point of chronology versus technology. So do you think that we are all going to be talking directly to our consumer, or out of business next year, or three years from now, or five years from now, or never?

MR. RAINES: I hope not. That is a great question. It is *the* question for investors. Part of this job is to make this a compelling investment for investors on Wall Street, and this is the question that comes up for investors. We hear a lot about Blockbuster and other companies. It is ironic because the Blockbuster offices are very modest and out in Grapevine (Texas). Our building was built by WebVan. And of course WebVan was going to just repudiate all the grocers and go online. I think it is ironic that we actually bought the building from them when they went bankrupt. So the brick-and-mortar company bought it from the digital. But we have spent a lot of time on this. I have spent a ton of time looking at broadband. We have had a lot of external—as well as internal—research and analysis done. Our point of view is that size of games; hard drives on the install base of consoles; download speeds; a series of technical factors; investments or lack of investments in fiber optics technology, in cable—all of that makes for a short and medium-term that do not show a lot of access into the market in the full-game download business. I think that past 2013 or 2014 we could see enough growth so that more than twenty percent of the people in American have broadband speeds that would allow you to do full-game downloads. There will be a pricing issue. Customers will have to sacrifice game consumption to pay for the broadband. There are lots of factors. So we do not see full-game downloads as the threat that you hear talked about in the short term. We do see that add-on content, episodic content can happen today. That business could grow medium double-digits today if we could get the friction out of it. So I think some may wonder why a retailer would support selling downloadable content in store. We think that we are going to be a better advocate for that consumer than what a website might be. And we are going to help that consumer learn. And if we can create some profitability for publishers in that world, the offering will explode, the quality will explode, and that will be good for gaming. And what is good for gaming makes gaming more complex—and we will be the answer to consumers.

MR. BOESKY: Okay, we have seen that with Apple, where Apple turned their physical retail into a touch point for consumer. And then the challenge is to make a game store, not mentioning any chains in particular, but to make a game store not feel like you are walking into your mother's basement, and people actually being helpful.

MR. RAINES: And Keith, there is a price point issue there, too. If you want consumers to pay more than $2, $3, $4 for games—everything, all our data, says consumers want a little bit of education, knowledge, advocacy to go with the beauty of an *Assassins Creed.* They want that to pay $59. If they are not getting all that, there is a question of whether they are willing to pay those price points. So we see that as the other facet of that digital side.

MR. BOESKY: But as a content creator, Christian, we talked about it where there may even be a chance that we may not have any more consoles—we may be delving into something. Do you really care?

MR. SVENSSON: Honestly, what is on the other end of the box is consoles, at minimum. I think they are still going to be around. And if for no other reason, because they are largely secure.

MR. BOESKY: Like PSPs.

MR. SVENSSON: Well, in the future, they are.

MR. BOESKY: You are not in on the inside joke—they say fifty percent of the content on PSPs is pirated.

MR. SVENSSON: There are certainly some platforms that are more or less susceptible than others to a piracy threat. I do think that vis-à-vis some open platforms where piracy runs, I think that is going to be one of the things where as we move into more digitally distributed content, that should by its network nature be increasingly secure or at least be able to be sniffed out as if this is fraudulent, or this box is compromised in some way, and it would be disconnected. Whatever devices are connected, and whatever devices people want to play on is where our content is going to show up. So I do not think it really matters what is at the other end of the pipe necessarily, as long as there is a pipe connecting and feeding content to it.

MR. BOESKY: And do you think that the existence or non-existence of GameStop is relevant, and one of those would be more positive than the other?

MR. SVENSSON: Let's remove GameStop as a specific . . .

MR. BOESKY: No, no, no—this is what we are doing because I took a long time how to figure out how to not put this on me. (laughter)

MR. SVENSSON: Oh, so it is on me? So GameStop will continue to be relevant for a number of reasons. I think Paul called it—there is always going to be a consumer that needs education. Retail always brings around the opportunity for impulse purchasing a physical object, even if it is a token in a box. And it is an infinitely more valuable gift experience if you will, around holidays, or birthdays, or special occasions. I mean, there is a lot of gifting that goes on in our industry, and retail is always going to be there to facilitate that. So there is no way that retail ever goes away. What I do see is a future where digital content is increasingly demanded by and delivered to the consumer. And I do think that in the longer term it will be certainly among a core consumer, which Capcom's brands obviously speak to. That is going to be the prevailing and most requested format that people want products in. They are not going to want discs—just like we do not carry CDs anymore, we carry around our iPods with our entire music libraries on them.

So too do people want to carry around their entire game library at some point in time when we move to physical devices. And so too I do not want to go fishing for discs in my office, I just want to fire up my game and play. So from a consumer convenience standpoint, I think that that is going to be the larger issue particularly for our audience. It is still in the early days right now. We are dealing with it, and if you look at it, it is already a decent business for us. That only shines light on how great things are going to be three, four, five years from now. We are dealing with a percentage of people who are connected. Then there is a subset percentage of those people who have never downloaded anything. And then there is a subset of that subset who have never actually transacted for real money. And when you talk to Microsoft or Sony or Nintendo, you kind of get a sense of what each of those three's percentages are. We are still super early, and I think that the fact that we have managed to make a reasonably good business out of it at this stage means the future is really bright for when we get ubiquitous connectivity. And a high percentage of those connected have actually downloaded something, and a greater than fifty percent of those people have actually transacted for real money. There is going to be a lot of opportunity here.

MR. BOESKY: I mean, my son is fourteen, and he has grown up in an environment where he feels that he controls everything on the TV screen. When I grew up, I watched what was on. And now, he only watches the things that he pulls in, and when it comes to gaming, he plays what he wants, when he wants, and I sat in front of a main emulator, multi-arcade machine emulator, and we played arcade games. And he was watching me and I was playing Indiana Jones—that ate a lot of quarters when I was in college. And he said, "Okay, so now do you put the quarter in Daddy?" And we had to put the quarter in to do it again. "Did you put the quarter in again now Daddy? This is when I would put the quarter in. And I could see him doing that with games. And Paul mentioned the price point, and it is something we are facing right now, which is value for price. We have had Blockbuster for a long time, where you can pay a subscription and get a game without paying anything incrementally. And we have Game Fly. We have got used games, so you can wait three, four days and get something at least ten percent less. We have really got to give the consumer a reason to buy this thing instead of rent it or just play the demo and be completely sated. And I understand that, but what happens on the other side when we have these channels that enable the publishers to deliver for less money? When Rocket E-Book and Nuevo Media came out and sold e-books at the same price as hard cover, they did not do well. When Amazon came out and sold e-books at less than half price as Barnes and Noble, they did well. We saw the same thing in DVDs. And when videotape movies came out they were $99, did not do well, dropped down to $29, and they went through the roof. So some publishers say that they can make just as much at different price points. Some say $29 some say $39 as they make it $59. How do you see that impacting each of you? First of all, do you think it is going to happen, and then how do you see it impacting you?

MR. SVENSSON: Want to go first?

MR. RAINES: Sure. I think there will be a market for that. And GameStop is a spin-off of Barnes and Noble so you can imagine we spend a lot of time on the phone with the Barnes and Noble guys with what is going on in publishing. So we understand the dynamics and so forth.

MR. BOESKY: Do you see that as a relevant model for game sales?

MR. RAINES: Well, it really is not. People want to make publishing music and movies analogues for gaming. They are really not, but when I say that, then I am accused of having my head in the sand, etc. So what we try to say is they will all be digital. What is different is the chronologies of each of them. I think that is a better way to represent it. We think there will be a market for full games. Those price points, I am not sure, it depends on the quality of the game, etc. Remember that a video game has a residual value in the mind of the consumer, depending on which focus group you look at. Consumers will tell you $15, $20, $25 is the residual value of a game. We only make $12 on a game, so there is an economic formula that has to . . .

MR. BOESKY: But doesn't the existence of the residual value, or the requirement to have a residual value where you are looking at it—and sometimes I have seen it compared by GameStop to an automobile purchase, which is more an investment looking at the resale value—don't you think that is saying that we may be charging $20 too much?

MR. RAINES: I think that if publishers can support reduced price points, it probably makes sense to do so. The thing that is not well-understood about the residual value economics is that used games and new games are two different market places. If you look at our fiscal 2008 data that we disclosed at Dice last year—we are about to update for this year—seventy percent of our trade credits go into new games. In other words, consumers bring us old games, and they use seventy percent of what they get in credit to go buy a new game. And only four percent of used games are titles released within the last 60 days. So what really happens with used games is that the used games opened up an opening price point market place for consumers who may not have bought new games. They cannot afford *Assassin's Creed 2* at $59, but *Assassins Creed* at $44, they can. They want to test it

MR. BOESKY: And they are saying that they are really price sensitive.

MR. RAINES: They are saying they are price sensitive. By the way, the same thing happens with consoles. The bigger installed base is good for gaming. What the buy-sell-trade model does is that it puts people into the opening price point that might not have otherwise done so and it makes a market for the premium consumer to ditch their inventory so they can fund new purchases. So I think that economics has to be understood on the digital side. A lot of publishers are understanding that and moving down that path. Development costs, I cannot speak to. Christian, I understand, is better. We hear about a lot of pressure around development costs and marketing costs. And those will still be there on the digital side. And then lastly, I think it is all about how if you can sell a digital copy at $29, how many can you sell, and how do you acquire that customer. Because customer acquisition continues to be a huge part of the spending in this business.

MR. SVENSSON: Short answer to the question, two parts: I think that there is always going to be a premium price point for certain types of content. I do think what digital is going to open up—we are currently in a market of haves and have-nots. There is an increasingly small percentage of titles responsible for an increasing share of the business, and anything in the middle ground gets squashed. I think what we are going to see digital start to open up is the ability for that middle tier to come back. We may start to see new IPs come out at $40 digitally, as opposed to $60 physically, and laying off some of the risks and some of the friction that does come from a retail distribution model. The other part of this is right now consumers have not demonstrated on most platforms a willingness to buy huge volumes of digital products at full retail prices, so I think you are starting to see to some degree what you saw on the book side of things of full price, physical book, priced same as digital book not working out so well. The Amazon model obviously did considerably better. I think if you look at X-Box Live and PlayStation Network to some degree, those, while again very nascent, we have had great success at $15 titles that deliver on a per-unit average contribution close to what a $29.99 retail product would deliver. That is great. I think that we are going to see very soon, maybe in the next 12-18 months, a viable $20 price point with product development budgets that are obviously not front-line priced, but for the right branded products, $20 is going to be a great deal for the consumer. Enough volume will be driven by the publisher to actually make that a viable model. I think $20 is going to be a whole new category of gaming that is completely separate from the $60 blockbuster.

MR. BOESKY: Now that is an interesting point—I want to expand that and then get back to the impact and the price disparity, but you are talking about a different game. On one level, we used to say a dollar an hour and you would have a $99, 99-hour game. And then we still said a dollar an hour and you had to have a 60-hour or a 40-hour game. And now we are down to 8 to 12 and multi-player, whatever that number is. Realistically, because we are distributing this one time at $60, we have created kind of an artificial construct, like the album was an artificial construct. You put together the songs people want to buy, and then you have to put in filler. Now you only sell the $99 ones that they want. A 22-minute television show that is a 30-minute show is an artificial construct, because that is how we sell TV time. A 90-minute movie is an artificial construct. So you are saying it will not be the budget, but do you see or do you know what the different type of game is? Do you see the game changing what you would want to make, and do you know what that type of game that would be in terms of scope and quality?

MR. SVENSSON: I mean, that is something that we have been digging into for a long time. Where we are finding success are games that either have an existing community around them and this game is meant to excite that community and extend it. Leader boards are only just the beginning—tournaments creating events that are outside the game. We are creating other linkages from within the game that take people outside the game and vice versa. Basically, we are building more services around the game-increases, which you will see more frequently on the digital side for a variety of reasons. The other part of that is that it will eventually give rise to new models. In the PC space, free play is here. And if anything, that is probably the biggest threat to a publisher, and also the biggest opportunity to a publisher depending upon how open-minded they are. There is a massive sea of change that is coming that is going to rock the status quo of publishers in the industry if they do not adjust their business models and scale their businesses accordingly. I am not saying free play is going to take over the world, but I think you are going to see lower entry points to a service of some form with content and additional services being fed through that pipe, and take your pick, whether it is micro-transactionally driven or subscription driven. That is where our business is moving, and where we have been sort of nibbling the edges of is trying to figure out how that works before we sort of take a full plunge, and we are doing that on $15 and $20 content, as opposed to $60 content in the near term.

MR. RAINES: I think that is a great point Christian makes about free play. In many ways the competition for the $20 digital game is not the $59 package game; it is the free MMORPG. We acquired a company in Dublin, Ireland, about five or six months ago, called Jolt Gaming, which is a browser game developer. We have learned that with Jolt, we can do some piloting in the first quarter and development costs are extremely low, so your ability to monetize in a premium model is really heavily dependent on the content you can build into the game. Also, we can adjust content almost daily. So if consumers tell us in-store they really like this weapon feature, or if a movie comes out that is vampire focused, our ability to create in-game features and game play revolving around that is pretty agile. And so I think the future is going to have, as Christian said, a lot of free models in there, and we are all chasing what Farmville has accomplished on Facebook. There will be a subset of consumers that will want their game play in shorter bits, and they will want it for free, and they will want the game adjusting to them at a far more rapid basis. If we do, rather than waiting a year for the new version of my favorite franchise to come out, if I can get every week new features coming at me, that could be a model, and so we are competing not with $59 games on those consumers, we are competing with free games.

MR. BOESKY: But do you think that is mutually exclusive? It is abysmal and horrible to think that we find success in penetrating one percent of our base and a major hit as ten percent of our base. That is just crazy. But, does it mean that coming out with a game like *Uncharted* or *Call of Duty* is mutually exclusive to coming out with a *Farmville* or something like *Trials*? Because we have a consumer that will watch *The Big Bang Theory* and *The Daily Show*. And then they will watch the *Sopranos*, and maybe buy the iTunes or downloaded or the DVD set, and then they will go to the movies when *Transformers* comes out. The only thing that says is that if we are going to invest the money to make *Transformers* or *Avatar*, then we have really got to focus on making it well and telling them that it is there, because we have seen success. What it seems that we have lost—and you guys may see it differently—but what it seems that we have lost is that whole middle tier of games of publishers saying, I will spend $5 or $10 or $15 and throw it out. But the big, big bets with the big budgets seem to work. And the little, little bets—in a market that never existed before, seem to be working—which is really exciting, actually.

MR. SVENSSON: The lower market has actually always existed. If you look at the Nintendo DS—the portable market in general—it is a very difficult market with very tight margins and there are really only two ways to win: either the lowest cost development with brand, or at the other extreme, as Nintendo did, and use your best talent, a big budget, multiple years of development, and tens of millions of dollars in marketing. There is no middle ground there, which has been typical of the portable market segment forever.

MR. BOESKY: Because it used to be that the top end was a million dollars and now that top end is $20 million.

MR. SVENSSON: That top end is $40, $50, $60 million and climbing. That is my big fear today in the conversations we have had internally. I am seeing budgets that are bigger and bigger—it has almost become an arms race. It is not going to take too many misses for anyone. Even if you have $2 billion in your war chest, it can get worn down after a $100 million miss here and there once cost of goods gets factored in.

MR. BOESKY: And we are working on a business, I mean the business was started when I was at Eidos. Tomb Raider cost $900,000 and made $200 million. We were able to cancel a lot of million dollar games. Our biggest game ever was *Final Fantasy 7 PC*, and we doubled our investment in the first royalty after it shipped. But you can make a lot of million dollar mistakes when you make $200 million in just one game.

MR. RAINES: Well, do not ignore that there also is a ton of intellectual property out there that is under-utilized or on the shelf or not being used at all. So one of the things we have learned about browser gaming is your ability to monetize publisher's IP when they do not want to spend the $30, $40, $50 million and turn it into a browser game. We have got a came called *Legend of Zork* at Jolt, and it is a simple little browser game, but it is old Activision IP they were not using. We licensed it and it can be very productive, so some of that IP gets recycled and rehashed into lower development costs on browser games.

MR. SVENSSON: And the other nice thing about that is you reinvigorate a browser brand that could then lead to a bigger title somewhere further down the line.

MR. RAINES: And then the publisher could decide, it wants to take the brand back after we build it up and then make a console game and profit. So there is some of that going on as well.

MR. BOESKY: Which is actually unique—we were talking about this before, and that is a great unique aspect of GameStop—you just care that things are flowing through your pipes, which actually makes you more like a Google, Apple, or Microsoft. Which is, "we want to monetize the channel and let you guys monetize the content." Because it could almost sound like you are a content investor when you talk about that.

MR. RAINES: It is not a buzzword; we are trying to bring power to the players. So the more we enable and empower game players with products they like and think is cool, the better off we will be. We will find a way to make money off of that. But it is all about growing the category and giving them what they want and giving them value and assortment. So, we do not want to be a content provider, what we want to do is take stuff that is on the shelf that nobody is using—to work with a publisher to make a quick and dirty game that will not make a lot of money. This at least gives the unwanted material some vitality and we give our consumers something else in the store that our competitors do not have. Because remember that we are trying to survive in a world where there are some very big players, and we want to be differentiated for the gaming consumer. It is a big part of what we do.

MR. BOESKY: Getting back to the digital downloads and the browser base that you are talking about, and really more to you, Paul, if a consumer buys something by digital download, or if they play that browser base game, then they do not have the physical SKU to turn back in, which would indicate that they do not see that $20 residual value, so they would want to pay less. But also, more significantly, is there a concern about what that does to the part of your business attributable to you? Because that is your supply.

MR. RAINES: Well sure there is. The used business will grow based on inventory, and remember that only thirty-five percent of our consumers even know that we have a buy-sell-trade model. So to us, awareness is a big part of growing that business. But I would argue that the statement that as downloadable content grows, some people see cannibalization as the reason used exists. We know from our data that we are not cannibalizing new sales; what we are doing is building an opening price point business. So the consumer who is buying that digital game is a leading edge consumer; they want the best and the brightest of the new games. What we are trying to do is we are trying to serve that $4 consumer, $5, $10—the average price of our used games is below $20. Most of them, the majority I think are in the PS2 platform, so we do not see those two as interfering with each other. We do need inventory, but there is $7 billion of old games underneath the couch in America. So that inventory is not drying up anytime soon. And to make that work, you have to have a factory that recycles them. There are not many ways to recycle other than through GameStop and when you recycle 100 million units a year it becomes an issue. So we see them as separate, Keith.

MR. BOESKY: So, if you are going to be doing the assisted sale, and you are going to be going through Capcommunity, then who owns the customer?

MR. SVENSSON: I will make it easy—we do. The reason people are buying . . .

MR. BOESKY: But I get emails from Paul all the time. I know he types up those PDFs every week with the two pictures.

MR. SVENSSON: Paul makes transactions, but you might say we own the customer. That person made a decision to purchase our content because they have some interest in that brand, interest in that type of game play, and we build the relationship with that customer. Capcommunity is our community site, and it is an initiative we started a couple of years ago. It is basically a social networking site that enables fans to connect to each other, set up groups, clubs, communicate via forums, they all have their own blogs, their own media uploads, fan fiction, fan art. It is a repository for everything as well as an editorial site where we have guys on staff around the world basically contributing stuff that happens within all our respective brand communities. We use that as a mechanism to drive them to our e-store, which is powered by Digital River—but that e-store sells both physical goods, so there is lots of merchandise, as well as physical software and digital software. Digital software as a percentage of that business today is actually relatively small. What is actually driving that business is merchandise: t-shirts, swords, *Resident Evil* controllers, joysticks. It is a multi-million dollar business for us. But it is largely driven by physical product than by digital product today. I do not know necessarily if that is going to flip. Our strategy on the digital side has been any outlet that has eyeballs or that people feel comfortable buying from is where we want our content being. I have 20 digital partners on the PC side that focus on different consumers, different territories, and obviously on the Microsoft, and Sony and Nintendo sides, we work extremely closely with all three of them to make sure that we are getting as much exposure for our content as possible. And still, we and EA are the only ones that have our e-store on the PlayStation Network. We were the first, and we had it six months before EA did. So we are working really, really closely with first parties to make sure that we are able to reach consumers. But I do view any channel as a means of reaching our customer. Not that I am touching their customers.

MR. BOESKY: I am working really hard to mix the innocuous with the kind of aggravating question to get you guys to fight, and you are just not falling for it. Paul, does he really own the consumer, and do you not care?

MR. RAINES: Well, look, we do not want—nor do we pretend—to own the Capcom consumer. We are agnostic in that respect; we support all platforms, all brands, all games, all publishers. We do offer more support for some platforms, brands, games, and publishers that we have a relationship with. However, the most important thing is what is best for the game player. If the right thing for the game player is to go to Capcom's site and buy *Resident Evil* controllers from them, then power to that player—they need to do that. Now, our game is that if you are a video game buyer and you buy across multiple categories and channels, you are a gifter, etc., you spend a certain amount of money during the year. I get all of that. GameStop has the leading market share, but we are by no means dominant, and we have huge competitors. I just want to get a little more of your spending that is discretionary. So before you go to another store, I am trying to get you over to me thorough a variety of means. Some of that is value, through buy-sell-trades, some of that is assortment, some of that is going to be a new loyalty program, promotions, ads, etc., so I would say we want to own the best experience in videogame shopping and retail. As far as being an enthusiast for a particular brand or title, we do not necessarily think we are going to do as good a job as they are on that. They know their games better than we do. But what we have learned is that consumer acquisition and customer retention in this space is a lot tougher than technology set-up. It is easy to set up a technology, like a social network. We have game and former.com, we have relaunched our website. Building that community is the hard part. Customer acquisition has a cost. We think we can play a role to support everybody in it.

MR. BOESKY: You just mentioned your competitors, and I know we have talked about browser-based games as competition, but there are also big box retailers out there who want to sell games and compete on price. This is really a different proposition, and they are changing what they do in other media. I talked to the guy who did the first exclusive record deal for Target, and it seems like our business would be right for the same reason. He said he looked out and said, "We are not selling very many CDs, but the music business is not advertising very many CDs. So let me take somebody that I know is a hit—let me take John Legend, and let me put some money behind this guy and do a network ad, because there is no music being advertised and put it in the store." And he did, and he sold a million units of this CD. And then they did more, and now we see it spreading through all the stores. Concerning the customer experience, if I go into Wal-Mart, I have to go to the back of the store; I have to look behind the glass; I cannot even pick it up. I have to make a purchase decision based on the cover, which means that the publisher has to advertise to reach 110 million people in a week. To buy it, I have to find a Wal-Mart associate that has a key and that can open the box and give it to me, which is difficult. We have seen Big Box retailers move in with the program that Activision did with *Guitar Hero*, which put it in a better position relative to *Rock Band* and brought it to market a year earlier. Without this program, they would not have had this advantage. Where do you guys see yourself fitting into Big Box retailers or their interest in games?

MR. RAINES: I think, we spent a lot of time on this, I think as a category specialist, you have to bet that your offering is superior to what the competitors are doing, and it is on several dimensions. So in terms of the service level, we have a smaller store—a lot of customers tell me our stores are too small. They probably are three weeks of the year, but the rest of the time they are probably about the right size. Unfortunately, I cannot move them around. But we invest a lot of payroll, more than our competitors probably, as a percent of sales on the category. And the reason we do is that you come to GameStop for advice, services, etc. So we believe in that. We believe we have got the broadest assortment. We have to have more assortment—we are the category specialists. So we will have two-to-three times the SKU count on any platform in our store versus them.

MR. BOESKY: And do you see that consistently moving?

MR. RAINES: I think they are going the other way, and we may be expanding. Honestly, what we see is that there are fewer and fewer titles, bigger bets. I see the competition buying fewer of them. I see our guys continuing to buy a pretty broad assortment. Now, the last one, of course, is value.

MR. BOESKY: It did not really work for Tower Records and Warehouse and Sam Goody and Crown Books—I can keep going.

MR. RAINES: The rumors of our demise have been greatly exaggerated. We will release financials in a couple of weeks, so you will see if we are still in existence, which we are, to our investors.

MR. BOESKY: You are buying your own stock, so you must know something

MR. RAINES: Yes, we are buying $300 million of it, with no debt. So, the value is the one we get a lot of questions about how we are going to compete with Wal-Mart with its big discounts? We have found that we cannot compete with anything that you can tape a fifty dollar bill to and put a pallet of down the main aisle. You only make $4 or $5 on a Wii—you are not going to put a fifty dollar bill on it.

MR. BOESKY: As a publisher that is great too, because you ship your product and then the first call you get is not from Costco, who decided to sell it as a loss leader. The first call is from Target, Wal-Mart, or GameStop, who want to know why you gave it to them to sell it for $29.99. This means you have to price protect. We do not like that either.

MR. RAINES: Well, it is what it is. People are going to choose loss leaders, and I have done that in other categories, and that is normal. But the question is, so how to compete with that? We believe that our competitive advantage lies in the buy-sell-trade model. In 2008, we put $700 million of trade credits in the hands of consumers. We will close fiscal 2009 around $700, $800, or $900 million, though we do not have the numbers yet. That is a $900 million subsidy to the category that we provide. Now, that is a tough value to compete with, and we are going to continue to compete with that rather than take an unsustainable markdown approach.

MR. SVENSSON: You bring up a couple of different things. You point out merchandising issues. Since 2000, Wal-Mart and Target have been talking about going to livestock. I just heard in my last call with our VP of sales that they are actually moving to the clam shell protective cases, which means products will be displayed as they are in Wal-Mart and tethered, so you will still need to get an associate to assist in getting the game.

MR. BOESKY: You still have to find those guys, and they are elusive.

MR. SVENSSON: It is a massive frictional element of that part of the channel. I also think we need to talk about who the Target guest is and who the Wal-Mart customer is vis-à-vis the GameStop customer? I think there is a pretty big market difference in who their average customer is. Target's customer, if you ask them, is Mom. So appealing content-wise to Mom, and marketing to Mom, and making sure Mom knows what Billy wants and comes and buys it at Target is probably more important than becoming a destination for the core gamer that GameStop really addresses as their core consumer.

MR. BOESKY: Don't you want Mom too, Paul? I mean, isn't that necessary for you to expand?

MR. RAINES: We want and we get a lot of Mom business. But we are stronger on our core demographic than we are on Moms. This is key because it is crucial for our category to determine where the category will go—will it become more expanded or more core?

MR. SVENSSON: The other part of this is Big Box Retailers picking up a SKU. I discuss this with my constituents in the publishing community, wondering if Wal-Mart will pick up this SKU or Target will pick up that SKU. Very often, the Big Box Retailers are cherry-picking certain titles; they are cherry-picking certain SKUs amongst a multi-SKU title.

MR. BOESKY: I do not want that M-title, unless it is going to sell a lot. And then I will take the M-title if you put it with a special box cover for me, and then I am going to call you up to pay to take it out of the store if it does not sell, and then you have to destroy that box because that is my box cover. That is a fun ordeal.

MR. SVENSSON: Those discussions do go on, and that is frustrating.

MR. BOESKY: And that is why we have to kill Wal-Mart! (laughter)

MR. SVENSSON: There are lots of issues that we have with Big Box that are different issues from those with GameStop that are different from those with Digital. There is no single channel that is the panacea. It is actually going to be a mix of everything that actually gets the profitability for everybody.

MR. RAINES: It is a tough category. I have worked in a lot of categories, and video gaming is a tough category. It is low cube. It is high-value per-cube. It is an assisted sale. It requires service and vast product knowledge, and it is a capacity constrained business. It is an intellectual property business on the publisher's side. So for retail, video gaming is a tough category.

MR. BOESKY: Okay, I want to ask you one question about the technology that we have heard about lately. And, then I am going to ask you a broader question about what you see as a future configuration, and then I am going to open it up to see if anybody has any questions. So, the first current issue is the new cloud companies. There are OnLive, Playcast, and OTOY, and they are all getting press. And many people believe that these companies and games of service are the future. Thoughts?

MR. SVENSSON: For those who do not know what cloud companies are, think of it as a streamed video stream coming down to you of what game is playing while that game is remotely playing on another machine somewhere else, typically a PC, and your inputs via controller also get passed through the internet or through some other network back to the machine where that game is playing. This is a first pass technology that we have seen, and I have deals with all of the major players except for OTOY right now.

MR. BOESKY: I can fix that for you if you want

MR. SVENSSON: It is wait-and-see. Confidentially, the business models that are offered to content creators right now are not where they would need to be to actually be a sizeable chunk of our business, even if they were to become the primary mechanism. There would probably have to be some renegotiation further down the line. That said, we are trying to understand the network services and are trying to see what sort of business opportunities and alternative models can be brought about from these network services. I am basically using them today as another means of monetizing our PC content specifically, because that is what they run—they are PCs.

MR. RAINES: Yeah, I agree with pretty much everything Christian says. Chronology versus technology is the question there—we have looked at everything with all of them. We do think that the business model is difficult to figure out. On the other hand, in regard to bringing game play into the marketing space, we have never had anyone do a good job of bringing two minutes of game play into a website. However, for example, if I could bring some game play into Gamestop.com and at the end of that, market to that consumer, that might work. We like that concept, but the business models are not clear yet. I think the technology experts will go back and forth on the feasibility. People better qualified than I will make that decision. But I think it is a chronology versus technology question.

MR. BOESKY: The broad question is, considering your vision of the future GameStop what would the future GameStop look like and what would the future publisher look like? If you did not have a legacy, if you were just building, what would you be building?

MR. RAINES: Five-year scenario?

MR. BOESKY: No, no, no, not five years—that is too far out. Just right now, to position yourself for the future, and where would you like the store to be? You walk into GameStop, and what is your experience?

MR. RAINES: I think it will continue to be a significant physical footprint . . . we will continue to have great opportunities to build our stores in neighborhoods around America. As far as in the store, it will be an agnostic aggregator of game play and game content, which will include physical product and digital download opportunities. Additionally, it will be a destination for game enthusiasts to be marketed to online digital properties, like browser games, or maybe kiosks that will be able to download or give you some kind of content that will go directly to your console, or to a PC, or to a phone. And at the same time, GameStop will still be the dominant player in physical product distribution.

MR. BOESKY: And what parts of those are not there right now?

MR. RAINES: We started GameStop Digital Ventures about five months ago. Chris Petrovic is our leader. He is in our L.A. office, so he is beginning to touch a lot of the technology companies. We are meeting with a lot of VCs and investigating a lot of emerging technologies. So that is probably nascent. We are piloting downloadable content at retail with the platform owners in the first quarter, and then there will be some browser game promotions in-store, probably in the first half.

MR. BOESKY: Christian, if you did not have a legacy and you did not have a home office in a foreign land, and you did not have all these other things, and you were building the publisher of the future based on the IP that you have and the market advantages, what would you look like?

MR. SVENSSON: I would try and build a cross-platform mechanism as soon as possible to deliver content to my consumers. I would want to empower those consumers in ways where they can contribute back into the ecosystems themselves, and maybe even participate. I have seen some models on the PC side that have been really interesting—the game *TrackMania* is good example of where I think the future should go. I would like to see an increased reliance on services. I would like to see front line price points come down so that we can touch more people more easily, more quickly, and so that you actually see more sustainable models that are not quite so frontloaded. I do not think that retail goes away, ever. But I would like to deemphasize its importance to our business and have more of a direct relationship with our consumer.

MR. BOESKY: Okay, get more aggressive and expand on that. I am just kidding. Does anyone have any closing thoughts before we open it up to questions?

MR. SVENSSON: Thank you for having us, it was good chatting. I think we covered a lot of ground today. I think we talked about where there will be a lot of these things materializing in meaningful ways. I think Paul and I probably differ in that I believe the time frame for all of this is sooner than what Paul thinks.

MR. RAINES: I think you are in a great category, those of you if you are involved with Guildhall. We have done a lot of research and gaming has a good future. The important part is the development of innovation and the investment innovation. How does that get distributed? By what channels? By what technologies? Where do the profit pools go? There is constant motion but the future of gaming is very bright.