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Nintendo: Horizontal Differentiation in an Oligopoly

“The game has changed, ... and the way the game is played has to be changed.”

—Satoru Iwata, president of Nintendo Co. Ltd (Malstrom)

Nintendo has been a major player in the technology and gaming industry ever since entering into electronics in 1970. While for years it dominated the market for virtual gaming, a rise in competition within the industry presented serious challenges for the company. After struggling for the first five years of the new millennia, Nintendo made an exceptional comeback with its innovative products, the Wii and the DS, that shook the market and brought in a whole new set of customers. Their new strategy was so successful it allowed the company to be ranked the second most valuable Japanese firm after Toyota in 2007 (Farhoomand 6). Despite its recent success, Nintendo must look ahead and act strategically as its competitors begin to adapt to the new market trends.

Market Background

The Birth of Gaming

The electronic gaming industry began with a few very basic games in the 1970s. At first, they appeared in the form of coin-operated machines in public places, with games like Pac Man and Donkey Kong before moving to home entertainment with hits like Atari’s Pong (Vaughan 13). A major shift in the quality of in-home gaming came with Nintendo’s release of Famicom in Japan and the Nintendo Entertainment System (NES) in the United States in 1983 and 1985 respectively. The company also led the handheld gaming industry with its release of the Gameboy in 1989. With the high quality of the NES, Nintendo held a virtual monopoly in the gaming console industry for five

years until the Sega Genesis was released in 1990. While the Genesis challenged Nintendo's elite status for a brief period, Nintendo successfully responded with its superior Super Nintendo Entertainment System (SNES) in 1991 and maintained its position atop the gaming industry.

A New Breed

In an ironic twist, Nintendo itself indirectly brought upon its next serious competitor. While developing the SNES, Nintendo was looking to implement the relatively new CD-ROM technology into the next generation system. As Nintendo views themselves as a gaming company as opposed to a technology company, they decided to outsource the project to Sony. However, after friction emerged between the two companies, Sony decided to take on the challenge of forming its own entire console, leading Nintendo to use Panasonic technology instead (Farhoomand 2).

Four years later, Sony released the PlayStation with a surprising amount of success. While teenagers previously comprised nearly all of the gaming industry's customer base, Sony was able to reach out to individuals in their late 20s and early 30s with significantly larger disposable incomes (Farhoomand 2). Despite the PlayStation's success, Nintendo was able to maintain its dominant position with the release of the N64, the last console to use cartridges, in 1996.

However, competition continued to increase as the industry entered the sixth generation with Microsoft introducing the Xbox¹. Sega led the new cycle in 1998 with the Dreamcast but was soon eclipsed by Sony's release of the PlayStation 2 (PS2) in early 2000. This dealt a final blow to Sega, who soon after decided to exit the console market and focus on software development, leaving three main competitors in the industry. The following year, Nintendo's Gamecube and Microsoft's Xbox were released just days apart. While the Xbox fared well, the Gamecube was a disaster, allowing the

¹ Microsoft was worried by the impact of the success of PlayStation on PC gaming, and decided to enter the market to hedge against its large stake in PC gaming.

PS2 to emerge as the clear winner of the sixth generation. Most experts attribute the PS2's backwards compatibility and its ability to play DVDs as keys to its success².

Resurgence by Disruption

Breaking the Cycle

Since the release of the NES, the gaming industry had been stuck in a cyclical process—every five or six years a new generation of consoles would emerge to compete with one another. Competition was largely aimed at vertical differentiation, with each company seeking to implement faster processing, better graphics, and more immersive games. In 2002, however, Nintendo appointed Satoru Iwata as the new CEO. Iwata noticed a shrinking population of gamers in Japan and blamed the high costs to consumers. While monetary price was certainly a factor, Iwata was more concerned with the homing costs associated with the newer systems. While more immersive games with a wider variety of button combinations provided substantial value to the committed gamer, the larger necessary time investment to learn the games was driving away the casual, marginal user (Farhoomand 4).

Nintendo therefore sought to horizontally differentiate their next system, the Wii, from the other seventh generation consoles and reach out to non-gamers. In order to simplify the gaming experience, they completely overhauled the way players communicated with the console. Instead of pressing combinations of buttons on controller, players of the Wii communicated with the console through movements of a wireless remote³. The company also implemented their new paradigm to the handheld market by replacing the Gameboy with Nintendo Double Screen (DS) in 2004. The DS also sought to simplify controls by having a touch screen as well as traditional button controls. These adaptations made the systems easy to use, quick to understand, and therefore appropriate for an untapped gaming market—particularly families looking for an inclusive experience.

² While Microsoft's Xbox also played DVDs, it required consumers to pay an extra fee for the software and remote.

³ The Wii was the first console to introduce wireless remotes.

In addition to simplifying controls, Nintendo adjusted the nature of their gaming content by focusing more on real life scenarios, with which the average person could relate, as opposed to fantasy type games that appealed more to devoted gamers (Vaughan). The big hit games for the Wii were simple sports games like tennis, bowling, and golf. Nintendo also introduced the concept of “exercgaming” with the Wii, with programs designed to assist, track and motivate users in physical exercises. The DS, on the other hand, had hits with games like Nintendog, where a player raised a virtual pet, and Brainage, where players completed puzzles and brainteasers (Farhoomand 5).

The company also decided to pursue a different marketing approach that was less focused on traditional media. They hired well-connected mothers in several suburban neighborhoods to praise the Wii amongst their social networks in an attempt to generate a word-of-mouth buzz. They also focused on marketing through ads on social networks and YouTube as opposed to Microsoft and Sony, who focused more on traditional print and media sources. The advertising campaign proved to be quite cost effective by later estimates (Farhoomand 6).

Aside from horizontally differentiating themselves, Nintendo made an effort to patch up their previous vertical deficiencies. The Wii utilized full sized discs, as opposed to the Gamecube’s mini discs, and was capable of playing CDs and DVDs. They also made the Wii the first internet-capable console to be able to run off of wifi. With new internet capabilities, Nintendo was able to upload games from previous consoles, making the Wii backwards compatible.

The Wii proved to be a huge success after its 2006 release, beating the combined worldwide sales of the PS3 and Xbox 360 between 2006 and 2008 (Farhoomand 23). The 2004 release of DS also proved strong, allowing Nintendo to control 90% of the handheld gaming market as of 2007, despite Sony launching a competing device, the PSP, in 2005 (Farhoomand 5). Sales continue to be strong with retailers selling 600,000 Wiis and 900,000 DSs in the most recent week (Ortutau).

Pricing and Markups

In addition to regaining the dominant market share in gaming consoles, Nintendo also made significant profits. A less complex system like the Wii is significantly cheaper to produce than the more advanced PS3 and Xbox 360. This trend also holds true for the development of games. So, while Sony and Microsoft must practice price penetration, Nintendo is able to turn a profit on each console and game sold. These numbers are significant; Sony takes a loss of about \$300 on each PS3 due to the expenses entailed in incorporating a Blu-ray player and advanced processing chips. Xbox, on the other hand, initially lost about \$125 per Xbox sold, but was able to increase production efficiency and cut marginal losses to \$75. They eventually incurred a loss of \$1.1 billion, however, when they were forced to extend all one-year warranty to three-year due to a defective chip and the infamous “ring of death,” bringing their total losses on hardware up to \$2 billion. Nintendo, on the other hand, makes just under \$50 every time a Wii is sold in the United States (Farhoomand 24).

Competition Ahead

Encroachment

While Nintendo successfully identified and exploited a new market, its competitors are eager to enter this newfound and lucrative niche. Both the PS3 and Xbox 360 have recently launched add-ons that afford users a similar experience to that of the Wii. The PS3 now has Sony Move, which features a wand that players use like the Wii remote. Microsoft, on the other hand, has come out with Kinect, which senses body movement and does not require the user to hold any sort of instrument. Both add-ons have sold well with Sony selling 4.1 million units in the first two months and Microsoft selling 2.5 million units in its first 25 days (Ortutau).

Strategy

Pricing remains Nintendo’s largest advantage over the other two competitors. Amazon currently lists the Xbox 360 and the PS3 bundled with their respective add-ons for about \$400, while a Wii lists for half that price, making the Wii the optimal choice for

users seeking motion-sensing controls. However, the add-ons alone cost around \$200 and \$100 for the Kinect and Move respectively, so it may be cheaper or of equal price for a current owner of either system to upgrade rather than buy a Wii in order to gain motion-sensing capabilities. This may be less troubling than it seems on the surface though, as individuals considering such an upgrade are likely avid gamers that were already outside the targeted market for the Nintendo Wii. The consumer base that is most vulnerable to switching from purchasing a Nintendo to an upgraded rival system is the households who may have one or two avid gamers as well as more casual consumers.

In order to persuade these users to buy a Wii, Nintendo must once again differentiate itself horizontally. Nintendo's largest assets are arguably its reputation and its intellectual property and these must be fully leveraged. The company is known for producing experience goods "that put smiles on surrounding people's faces" (Message from the President). New games based on characters from Super Mario, Pokémon, Zelda, and others are in high demand and Nintendo has exclusive rights to produce them. Nintendo has also recently made a good move of reaching out to Disney to make *Th!nk Fast*, a jeopardy-like game, and *Epic Mickey*, with Mickey mouse as the main character. This partnership makes perfect strategic sense; it adds to the kid-friendly, family-orientated reputation of Nintendo while bringing additional high-valued, exclusive characters that consumers are willing to pay for.

Nintendo should capitalize on this reputation more. Having gained the trust of parents with decades of relatively nonviolent, fun games, the company now has the opportunity to move into educational games. Educational programs could be aimed at many ages, from simple spelling and math games for second graders to virtual driving lessons for sixteen year olds. By labeling itself as a tool for families, Nintendo can establish itself as a staple for every household.

It would also be wise for Nintendo to further integrate the DS and the Wii. While users can currently transfer some data between the two systems, it is not explicitly advertised and not particularly easy to do. When an individual buys a Wii game, it should come with options for play on the DS. This could include a simpler version of the game with less advanced graphics, or specialized mini games, so people could take their game on the go and continue to add to their characters' progress. Nintendo should also consider

making the DS function as a Wii remote. By creating a more cohesive set of systems, Nintendo can grow a more loyal consumer base and build a better reputation.

Finally, Nintendo needs to keep pace with emerging technology and trends. While it is important to keep costs low and products simple to use, the company cannot afford to ignore changes in the market. They seem to in line with this sentiment as well; Reggie Fils-Aime, President and COO of Nintendo of America, recently said, “We’re going to innovate on the hand-held front [with] 3D gaming, and for us it’s [about] marrying that technology with content” (Lodge). Developing handheld 3D gaming would certainly boost Nintendo’s standing in the industry. In addition to pursuing 3D technology, Nintendo must continue shifting towards digital distribution of material and transforming its main console into a complete home entertainment system to keep pace with Microsoft and Sony.

Conclusion

Amongst the big three competitors in the gaming industry, Nintendo has stood the longest. While it lost its dominance by being vertically outperformed, it regained its composure by horizontally differentiating itself and offering a different, more intuitive system at a cheaper price. As Sony and Microsoft begin to compete for Nintendo’s new consumer base, the company must utilize its image and assets and continue to differentiate itself. Nintendo must also seek to undercut its competitors’ costs and stay abreast to emerging trends while continuing to integrate its gaming systems to create a cohesive consumer experience.

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