

Japanese Game Industry

1-1 Market Size in Japan

• Games

The ¥314.1 billion in [Game Software] shown in [Table 1] represents the sum calculated from the shipment amount of packaged software for home game machines and game software for personal computers. The ¥82.1 billion in [On-Line Game] represents the total of on-line game operational service sales and on-line software. “Arcade Game” means the amount of sales recorded at game centers that have game machines. “Mobile Phone Game” is the estimated sales of games distributed via mobile phones.

While game sales have declined, a market recovery is anticipated through the sale of new-generation hardware in 2006.

Additionally, over the past two to three years there has been a rapid expansion of the on-line game market.

[Table1] Game Market (¥ billion)

	¥ billion	Source
Game Software (05)	314.1	A, B
On-Line Game (05)	82.1	C
Arcade Game (04)	649.2	D
Mobile Phone Game (04)	58.9	E
Total	1,104.3	

A CESA Press Material <http://www.cesa.or.jp/>

B Japan Personal Computer Software Association Fiscal 2003 “Survey Report on Trends of Personal Computer Software Market”

C On-Line Game Forum Survey “Statistical Survey Report on On-Line Game Market 2005”
<http://www.onlinegameforum.org/>

D Japan Amusement Machinery Manufacturers Association “Fact-Finding Survey Report on the Amusement Industry”
<http://www.jamma.or.jp/sangyou/main.htm>

E Estimates made on the basis of the Ministry of Internal Affairs and Communications “Present State and Problems of Network” and materials from the Mobile Content Forum

1-2 Import/Export of Games

● Games [Overseas Shipment] ¥232.6 billion (home game software)

(Exports)

Many software manufacturers for games develop programs by taking into consideration the revenues and expenditures of overseas sales volume. These companies ship products under their own brand names through their overseas subsidiaries. Companies without overseas subsidiaries consign Japanese hardware/software makers for games with overseas subsidiaries in order to commercialize their products and receive licensing revenues. According to the Computer Entertainment Suppliers' Association (CESA), overseas shipments in 2004 amounted to ¥331.8 billion in hardware and ¥232.6 billion in software, as shown in [Table 2]. However, there has been no increase in the export amount of games, while exports of game hardware have shown a conspicuous decline.

Moreover, on-line games from Japan have made few inroads into overseas markets. They would sell the rights to their products to overseas companies, but the number of titles that are serviced abroad is limited.

(Imports)

Regarding game imports, Japanese companies would buy the rights from overseas manufacturers and sell them through domestic manufacturers. One of the titles that sold by more than 1,000,000 packages was [Tetris], in 1988. No other foreign brand title has recorded such significant sales, because domestic titles have an overwhelming share of the market.

Additionally, the on-line game market share of overseas brands serviced in Japan has increased. [Tables 3 and 4] show that overseas brands account for more than half the market share, with titles from South Korea at 22.4% and American-made products at 30.5%.

[Table 2] Game Shipment Volume by Domestic and Overseas Markets

	Overseas		Domestic	
	Hardware	Software	Hardware	Software
Year 2004	331,816	232,655	108,886	235,757
Year 2003	586,122	199,259	118,391	230,591
Year 2002	648,016	225,513	139,669	249,208

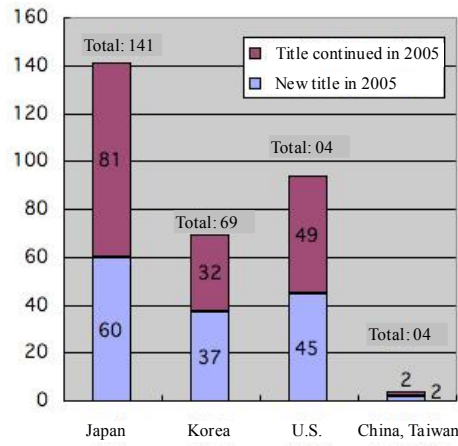
Source: CESA, "2005 White Paper on CESA Games" (¥ million)

[Table 3] Number of On-Line Game Titles by Countries Provided in Japan in 2005

	Japan	S. Korea	U.S.A.	China/Taiwan
New Titles in 2005	60 (41.7%)	37 (25.7%)	45 (31.3%)	2 (1.4%)
Titles Continued in 2005	81 (49.4%)	32 (19.5%)	49 (29.9%)	2 (1.2%)
Total No. of Titles	141 (45.8%)	69 (22.4%)	94 (30.5%)	4 (1.3%)

Source: [2006 Statistical Survey Report on On-Line Game Market], by On-Line Game Forum

[Table 4] Number of On-Line Game Titles by Countries Provided in Japan in 2005 (graph)



Source: [2006 Statistical Survey Report on On-Line Game Market], by On-Line Game Forum

1-3 Industrial Structure of Games and Domestic Transactions

- Software for Home Game Machines and Personal Computers

The hardware manufacturers for home game machines are Nintendo, Sony Computer Entertainment and Microsoft. These three companies sell software bundled with their machines. The 93 regular member companies of CESA and approximately 40 software houses surveyed by Media Create sell software under licensing agreements with these hardware makers in order to become rights owners. Software production is done in-house by hardware/software makers and major software houses. Along with in-house development, these companies often outsource production to approximately 200 software development companies.(Media Create Soken, Town Page). Some of the major development and production companies not only develop software at the order of software houses but also conclude licensing contracts with software houses and own rights to their products.

Additionally, partial production companies and individual creators would involve themselves in production as the producer, director, programmer, graphic artist, script writer and music producer within the development departments and development-production departments of these manufacturers.

Regarding distribution, the manufacturers sell their products to some 29,582 retailers (“White Paper on the TV Game Industry”) including specialty game stores, composite video stores and record stores through approximately 20 software wholesalers (Media Create Soken) for home game machines. Also, SCE has its own route to wholesale products directly to retailers without going through wholesalers.

- On-Line Games

On-line games totaling approximately 300 titles (“White Paper by On-Line Game Forum”) include originally developed products, licensed products of overseas games and those converted under license from programs for home game machines. Approximately 100 on-line game publishers, including 26 participants in the On-Line Game Forum, are distributors.

Like the software developed for home game machines, the production of these programs is done in-house by the publishers; through development/production companies and through licensing contracts with overseas firms. Under these arrangements, partial production firms and individual creators also become involved in production.

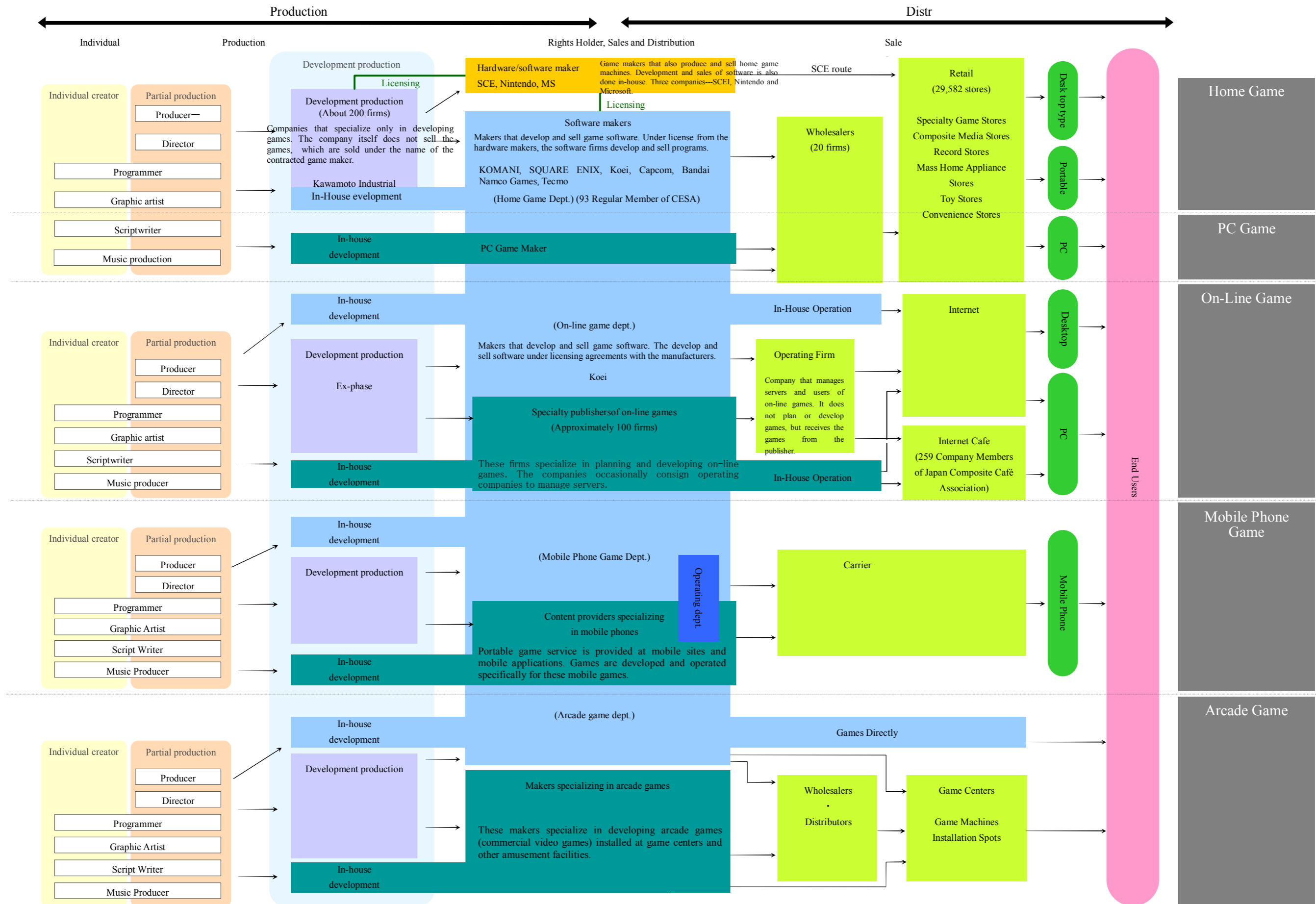
Regarding distribution, the publisher or the operating company consigned to handle the distribution

by the publisher creates the distribution system and operates the site. The user pays the fee via credit card, pre-paid card or by purchasing a play ticket. Additionally, users can play games at Internet cafés, including the 259 member companies of the Japan Composite Café Association.

- Mobile Phone Games

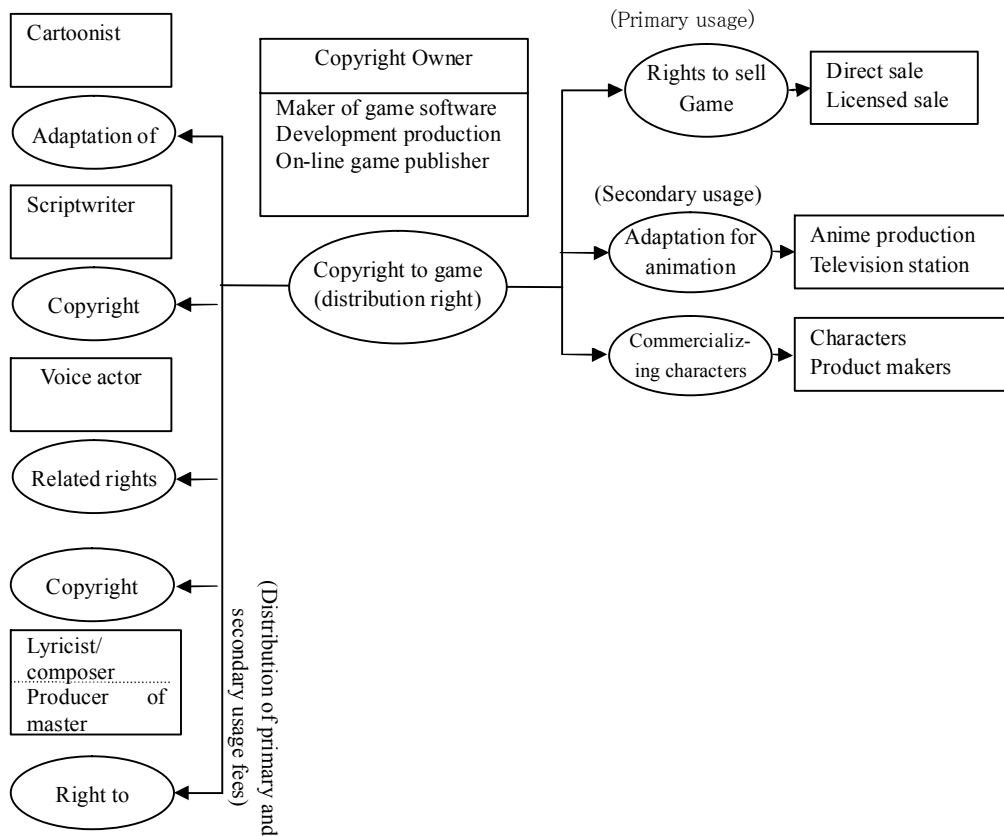
There are games specifically developed for mobile phones and home game programs customized for mobile phones under licensing agreements. There are some game software makers that operate the distribution sites on their own, and there are game developers, which own rights, that supply game contents to content providers within the 222 member companies of the Mobile Content Forum. However, in all cases the distribution and billing are done by the three mobile telephone carriers.

[Table 5] Structure of Game Industry and Domestic Transaction



1-4 Structure of Game Rights Transactions

[Table 6] Structure of Game Rights Transaction



In many cases the game manufacturer that sells games has the copyright to the game software for home use. When the manufacturer consigns an outside development-production firm to develop the software, the development-production firm has the rights enabling it to obtain right-based revenue from the seller.

In regard to cartoons and animations based on an original work, a secondary usage fee is paid to the copyright owner of the original because the game product is the secondary copyright work of the original. Additionally, voice actors performing in the game have related rights as performers. Secondary usage fees are also paid to music composers, lyricists, singers and record producers based on copyrights and related rights.

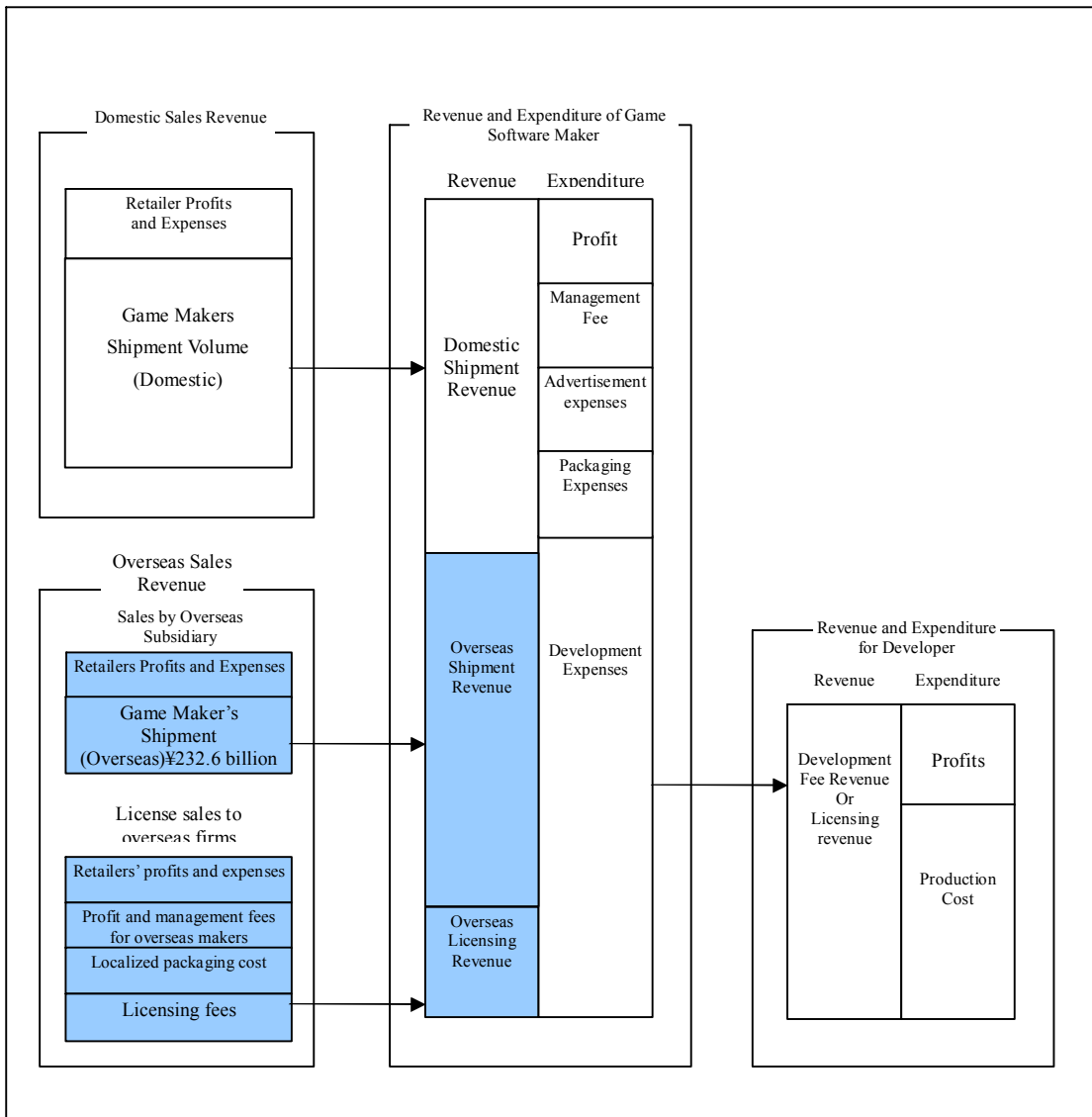
In the event a game is made into an animation work, an animation right fee is paid on the basis of adaptation rights from the animation production committee. Additionally, in the event character products are sold, the company making the character product pays character license fees to the game maker.

Regarding on-line games, in many cases the publisher that develops and operates the games owns the copyright. With regard to unfolding overseas business with on-line games, there are cases where the company's overseas corporation provides the service and where overseas publishers are licensed to receive monthly usage fees. From overseas companies, the initial licensing fee and a monthly usage fee is paid.

1-5 Revenue and Expenditure Structure and Fund-Raising Method for Game-Related Corporations and Contents

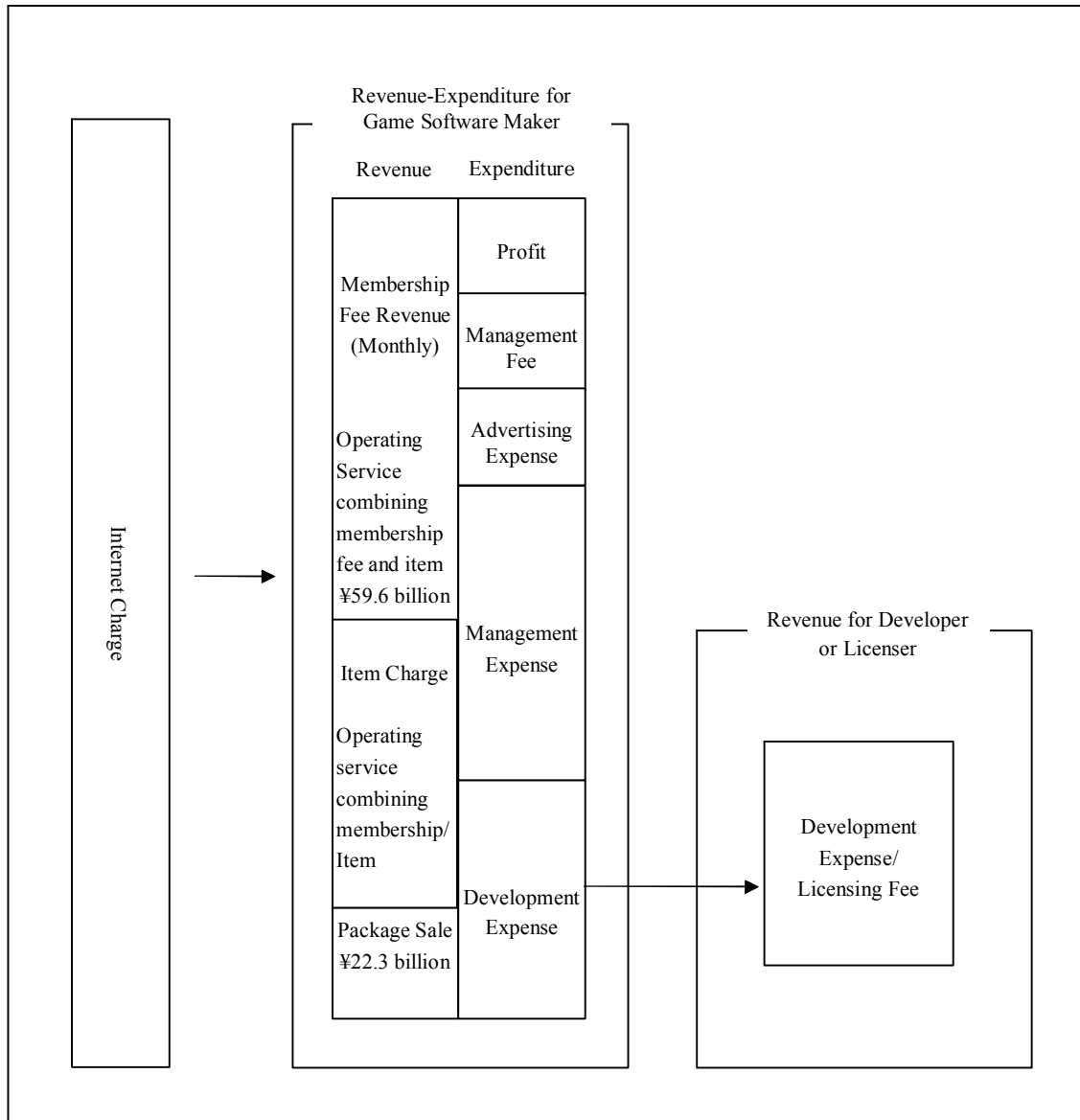
A majority of game software makers develop programs in anticipation of revenues and expenditures from overseas sales. There are occasions when the maker's overseas subsidiary ships out the software under its own brand name. In other forms of overseas sales, revenues are received through licensing agreements with Japanese makers of hardware and software, as well as with makers of game software.

[Table 7] Revenue-Expenditure Structure for Home Television Games



When unfolding overseas business for on-line games it is necessary to license an overseas company to service the games, or it is necessary to have one's own overseas corporation provide the service. Services are initiated when localized development is performed for the respective countries and by raising membership fees on the basis of such rights.

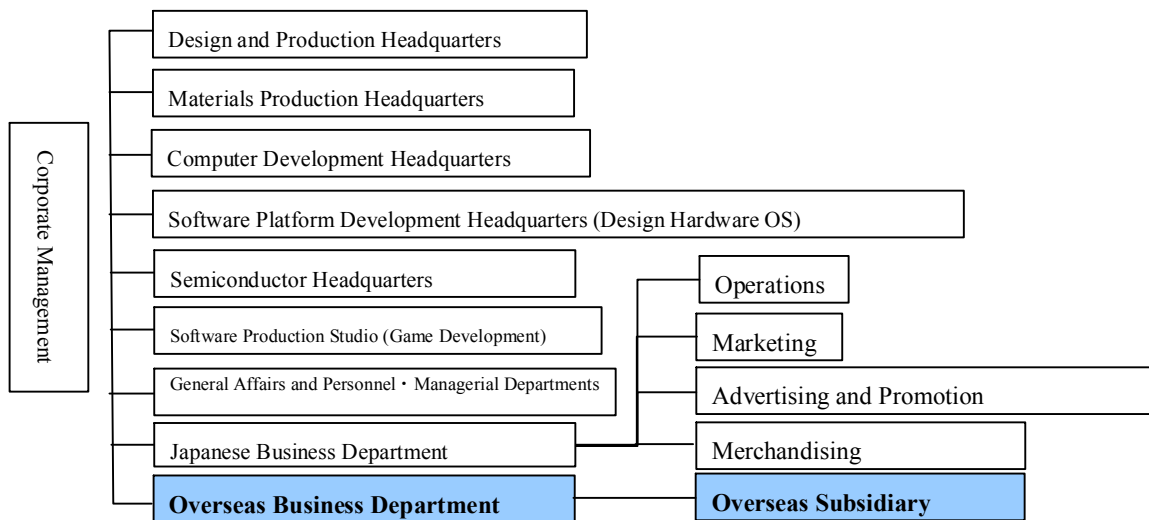
[Table 8] Revenue-Expenditure Structure for On-Line Games



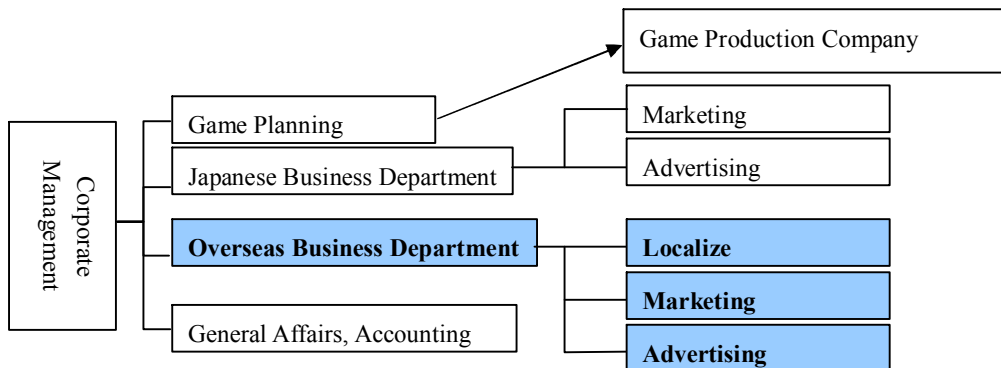
1-6 Corporate Structure Relating to Games and Department in Charge of Overseas Transactions

Manufacturers that produce hardware as well as software for games and major software companies have overseas corporations that sell hardware and software under their brand names. Other software firms have departments that handle overseas business in their marketing departments and sell their products under licensing through the overseas subsidiaries of Japanese software companies. Even if developers have ownership rights, in many cases they have software firms handle the overseas transactions.

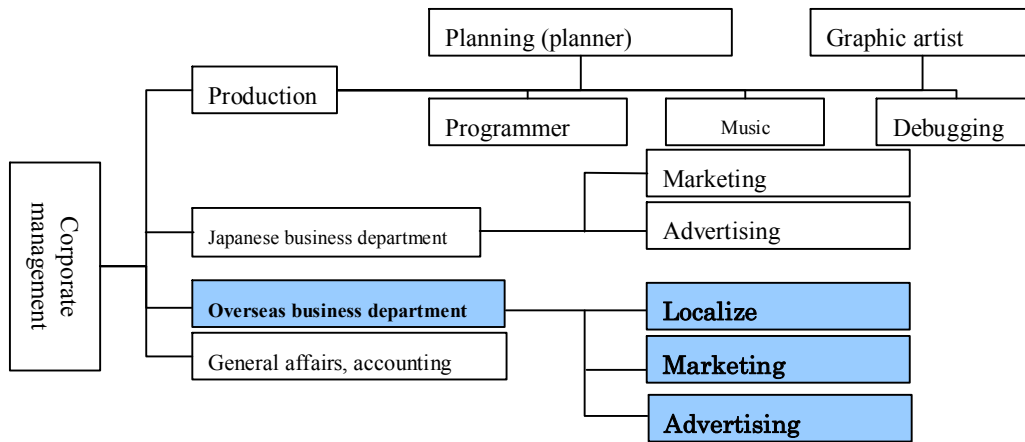
[Table 9] Corporate Organizational Structure for Makers of Hardware and Software



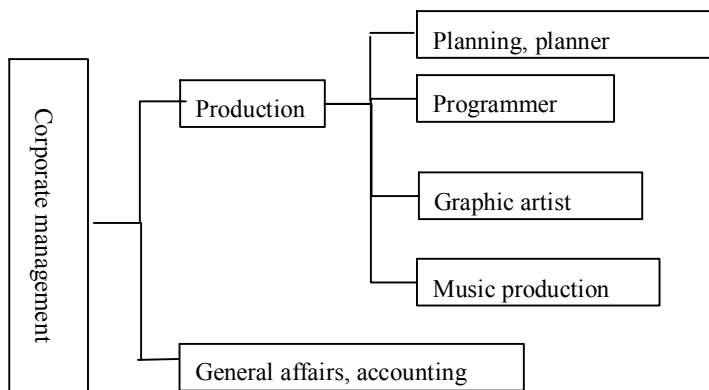
[Table 10] Corporate Organization of Software Maker (Mainly Publishing)



[Table 11] Corporate Organization for Software Maker (in-house production)



[Table 12] Corporate Organization of Development Production



1-7 Overseas Sales Percentage and Positioning of the Overall Industry

Overseas shipments of home game hardware in 2004 amounted to ¥331.8 billion and software came to ¥232.6 billion. The figures for domestic shipment were ¥108.8 billion for hardware and ¥235.7 billion for software. As shown above, the Japanese game industry's overseas shipments of hardware had always topped the domestic shipments, while overseas shipments of software were basically on par with domestic shipments. Thus it is the only export-oriented industry among Japan's content industries.

Accordingly, the major software makers for games develop their products in consideration of revenue and expenditures related to overseas sales, and many of these firms ship products under their own brand names from their overseas subsidiaries. Companies that don't have overseas subsidiaries will consign Japanese hardware/software makers with overseas subsidiaries to commercialize their products and obtain licensing revenues.

However, exports of home game products are declining, and there has been a marked drop in the exportation of hardware. The industry is watching carefully to see whether the sales of new platforms by Japanese hardware makers in 2006 will cause overseas software sales to regain momentum. Moreover, due to spiraling production costs there is a concentration of software sales only on the standard series of software whose sales are virtually guaranteed, and therefore it is difficult for new titles to enter the market.

The on-line game market is expanding on a global scale at the expense of home games. The on-line game market in Japan in 2005 totaled ¥82 billion. However, Japanese on-line games have made few inroads into overseas markets, thus compelling companies here to sell their rights to overseas companies. The number of titles serviced overseas is limited. Only a few on-line game titles developed by the Japanese are being sold overseas, such as "Crossgate" by Square Enix, "Headlock" by GungHo and "Cruz del Sur" by Koei. It is expected that many titles will try to cultivate markets in Asia. Games for mobile phones are being sold under license in Asia, Europe and the U.S.

1-8 Target Markets by Area

Similar to Japan, there are software markets for home game machines in the United States and Europe. Moreover, there are also problems of pirated versions in Asia. Consequently, there isn't much Japanese hardware for home game software in Asia. Under these circumstances there has been a proliferation in on-line games. Therefore, the game market in Asia is primarily for on-line games.

The volume of shipments of game software in the U.S. is approximately three times the volume in Japan, and the sales amount about twice the level of Japan, at ¥550 billion. While Japanese software once commanded a market share of approximately 50%, it is said to have declined to a market share of approximately one-third. The cause of the decline is not attributable to the sales environment or the pricing policies but is due to the popularity of American-made software. The American preference appears to be toward games with plenty of reality images using realistic subject matter such as combat sports and war games. These are areas where American makers excel. They are also popular in the market. About 10 major retail stores covering 50% to 60% of sales in the U.S., while the rest is sold through sales agents known as "reps."

Sales in Europe are ¥171.3 billion in Britain, ¥69.6 billion in France and ¥59 billion in Germany. When combined, the size of these European markets is approximately equal to that of Japan. It is necessary to localize the products by language in the respective countries and corresponding to their ratings, so the profit efficiency is low. Even in Europe the reality-oriented American software products, such as car racing and sports games, are popular. Consequently, the market share for Japanese software is declining.

Many of the Japanese software makers sell directly to retail stores through their own corporations in European countries. But in other regions many software companies sell products under their own brand names using the distribution channels of other publishers.

Japanese hardware and software products for home games are being sold throughout the region of East Asia, including China, South Korea and Taiwan, but there is no indication that the sales amount and volume are increasing.

While China has a huge market potential, prices have leveled off and pirated editions continue to proliferate. Given such circumstances it is believed that it will be some time before home games are established as a full-scale business. Success depends on how one ties up with leading local enterprises (licensees).

Manufacturing and sales require government permits. Therefore, it is necessary to determine whether participating in China's show for game software (China Joy) is worthwhile.

South Korea has many on-line games for personal computers, presumably because the broadband technology had spread throughout the country faster than it did in Japan. It is said that the proliferation rate of PC on-line games is among the highest in the world, and the market size is among the largest. There were 25 titles of Japanese game software compared with 37 titles from South Korean makers in 2005. Accordingly, South Korea tops Japan in terms of new title releases.

Even in Taiwan, there are far more users of on-line games for PCs than there are users of consumer game machines. Large numbers of on-line games licensed by American and Korean makers are being used.

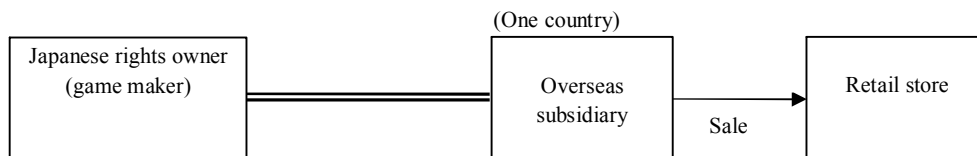
1-9 Examples of Clients and Sales Routes for Overseas Sales

Only two Japanese companies---Sony and Nintendo---produce hardware and software, but they have an overwhelming market share worldwide. They sell their products through their overseas corporations. Major makers specializing in software also have their own overseas corporations for sales of export-specification software under their own brand names. Software firms with no overseas companies sell their rights to software companies and companies with both software and hardware capacity that have companies in overseas markets, and then consign them to commercialize their products in order to receive their share of revenues.

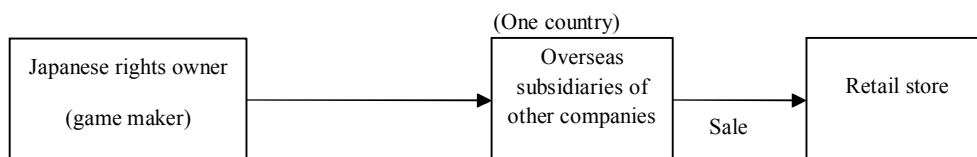
The overseas companies of specialist software firms and hardware/software makers supply large retail stores through wholesalers or by direct sales. In the past, products developed for the Japanese market were converted into overseas versions with few modifications. However, due to market growth and user diversification, the manufacturers have structural setups in various parts of the world to simultaneously develop products to the tastes of those regions, including Japan, North America and Europe.

[Table 13] Main Overseas Sales Routes for Games

(1) Selling game software through their own overseas subsidiaries in various countries



(2) Consigning overseas subsidiaries of other companies to sell game software in each country



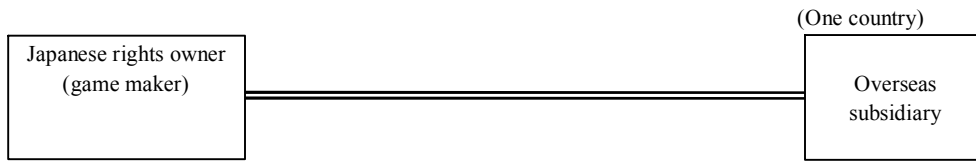
The monopolization of distribution in the U.S. and Europe has become a problem in terms of home game sales. Consequently the retailers have become increasingly vocal, and there has been an increase in the volume of returned products. Securing profits in the U.S. is more difficult than in Japan because even after the products are sold to the retailers and they sell a \$49 product to the consumer for \$39, they would demand compensation for the price differential of \$10.

While Japanese on-line game manufacturers had a slow start in cultivating overseas markets, one Japanese

game--called "Cross Gate"--shipped to China via a Taiwan firm in 2003 and became one of the 10 best sellers in China. With this popularity it was acknowledged that Japanese on-line games could be sold in East Asia. There are two ways to sell on-line games in overseas markets: The first is by selling operational rights to an overseas firm through an agent; and the second is for the Japanese company to establish an overseas subsidiary to provide the service. Koei has begun unfolding its business in South Korea in order to sell its rights for the "Cruz del Sur Online" program. A company called Excite has established an overseas corporation in Singapore to function as a support firm through hosting for the operation of services by the overseas subsidiaries of Japanese companies. Services have been provided since 2005 in six countries of Southeast Asia.

[Table 14] Main Overseas Sales Routes for On-Line Games

(3) Servicing on-line games through one's overseas subsidiary on a country-by-country basis



(4) Consigning Service of On-Line Games to Overseas Service Firms on a Country-by-Country Basis



1-10 Method for Cultivating Overseas Customers

In addition to Japanese hardware/software makers of games, some of the leading software firms are selling their products abroad by establishing overseas subsidiaries. Moreover, software firms without overseas subsidiaries are selling software by licensing their rights to the companies mentioned above. Accordingly, Japanese manufacturers have secured their general sales routes for products that conform to overseas demand.

At issue here is their relationship with the retailers in Europe and the U.S. Compared to Japan, the retailers in the U.S. and Europe have a strong say in business. The loss resulting from returned goods and price cuts is considerable. What is sought is the improvement of relations with retailers, as well as a way to secure reasonable profitability.

Regarding on-line games, increasingly firms are expanding overseas by finding service providers in various Asian nations through licensing contracts, or by providing one's own services by establishing subsidiaries in these markets. Currently, there is no trade fair where one can meet overseas operators for on-line games. There are possibilities for Japan to take the initiative in organizing these international events. Additionally, some know-how will be required to establish and manage subsidiaries to operate on-line game services in overseas markets, and the markets could open up by providing support.

Licenses for mobile telephone games are lately being sold in overseas markets. Consequently, displaying them in trade fairs could become a means to cultivate customers. Moreover, there are examples where services are provided by tying up with overseas companies that operate mobile phone games. Knowledge regarding tie-ups with international companies is becoming a necessity.

1-11 Joint Production With Overseas Companies, and Format Sales

While no joint production is being undertaken with an overseas maker in the game industry, companies are beginning to form ties with overseas firms. As examples, we are aware of the following:

Capcom has acquired Canada's Cosmic Infinity, which deals directly with mobile carriers, making it possible to provide service and acquire customers through the North American content distribution network. Capcom has the rights to convert popular television programs in North America into mobile telephone games, and it has the distribution rights as well. Moreover, because it has the know-how to transplant games into mobile phones, it makes it easier for the company to capture the right users. It is scheduled to open a development office in Los Angeles, and it plans to promote game development by working together with its Canadian base.

