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# **Nintendo's Disruptive Strategy: Implications for the Video Game Industry**

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## **Executive Summary**

Nintendo, one of the leaders of the electronic video gaming industry, has a long history. Its roots date back to 1889 where its eventual founder, Yamauchi, was manufacturing playing cards (Farhoomand, Joshia, & Tsang, 2009, p. 2). Since that time Nintendo has taken a strong stance in the video game industry. It has released many successful consoles including the NES, the Super NES, and the GameCube. However, in recent years, it has based its success on the highly innovative DS and Wii systems. The company has come a long way since its days of making playing cards.

In the early 2000's, Nintendo was facing tough competition from Microsoft's Xbox and Sony's PlayStation consoles. It was not until 2006 when Nintendo introduced its Wii system that it started to regain some of the video game prowess it held with previous systems such as the original NES system released in 1985. The disruptive nature of the Wii hinged on its ability to attract individuals considered non-gamers or casual gamers. The Wii was not as powerful or technologically advanced as the Xbox 360 and the PS3, but its successes were in its ability to provide a new means of playing video games. The innovative design of the Wii's controller, which had built in motion sensors, created a whole new gaming experience for users - one that appealed to a much broader audience. By avoiding complex and costly hardware, Nintendo was able to sell its console at a lower price than its competitors, while still making a profit on each console that it sold. Nintendo's new gaming system, the Wii, turned out to be a big hit for the industry.

Seeing the success of Nintendo's Wii, its rivals Microsoft and Sony, will likely respond with similar technologies. Therefore, Nintendo needs to continue to innovate and improve on the design and performance of the Wii. The company might consider exploring partnerships with hardware providers to improve performance, continue to develop in-house games, and also engage with experts from health agencies and providers to promote "exergaming." Now that they have successfully disrupted the market, Nintendo should not sit back on its laurels. The video game industry is a competitive market and the battle has just begun.

# Contents

- List of Figures . . . . . iv
- 1 Problem Identification 5**
- 2 Data Collection 6**
- 3 Analysis of Facts 9**
- 4 Solution Development 12**
- 5 Findings and Managerial Recommendations 12**
- References 16**
- A Figures & Tables 18**

# List of Figures

- A.1 Profit Margin Trends Between 2005 and 2008 . . . . . 18
- A.2 Gross Margin Trends Between 2005 and 2008 . . . . . 18
- A.3 Gross Profit Margin per Console . . . . . 19
- A.4 Cumulative Sales per Console from Sept. 2006 to June 2008 . . . . . 19

# 1 Problem Identification

Nintendo, a video game company, operates in a competitive industry where major product cycles average every five to six years. Nintendo's main competitors included Microsoft and Sony, with their Xbox and PlayStation consoles (Farhoomand et al., 2009, p. 4). In the early 2000's, Nintendo was struggling to find footing in a market that was dominated by Sony's PlayStation 2 (PS2) and Microsoft's Xbox (Farhoomand et al., 2009, p. 1).

With the next major console release cycle, in 2006, Nintendo released its Wii console. Around the same time, Nintendo's competitors released the Microsoft Xbox 360 and the Sony PlayStation 3 (PS3); however, it was the Wii that turned the market upside down with its disruptive nature. The term, disruptive innovation, was brought forward by Clayton Christensen, a professor of Business Administration at the Harvard Business School. It describes a process or strategy that allows a product (e.g., the Wii) to take position at the bottom of the market and eventually gain so much momentum moving up in the market that it displaces other well-established competitors (e.g., Xbox and PlayStation) (Bainbridge, 2011, p. 108). The disruptive innovation for Nintendo turned out to be a real hit for the industry.

Now that Nintendo was able to turn the tide with its Wii console, it now needed to determine how to continue to ride the success wave into the future. Its competitors were likely thrown off by the success of the Wii and its ability to break into new markets. However, it is quite likely that these powerful companies will try to mimic the most innovative aspect of the Wii, the motion sensing controllers, in the near future. Nintendo was first in introducing gaming at such a large scale to these markets, and will need to use this to their advantage as they decide how best to move forward and continue with the success of the Wii. Nintendo needs to clearly define its goals and act strategically to improve its design and gaming systems, and most importantly, remain innovative in this competitive industry.

## 2 Data Collection

Nintendo has a long history in the video gaming industry. Since the US release of the original NES in 1985, Nintendo has enjoyed many successes in the video gaming market. Other successful consoles included the Game Boy, Super Game Boy, Super NES and the GameCube. However, in recent years, the market has become more competitive with the growing presence of Sony's PlayStation and Microsoft's Xbox gaming consoles. The gaming industry tended to have new consoles introduced every five to six years. In the early 2000's, the cycle included the GameCube console from Nintendo, the PS2 system from Sony, and the Xbox from Microsoft. Of these three consoles, the PS2 became the clear winner. By 2008, the PS2 had sold more than 140 million units worldwide. Contributing factors to its success was the console's backwards compatibility with games from the first PS, and its ability to play media and video content on CDs and DVDs. Sony used the PS2's ability to play DVDs as a selling point since this technology had not become entirely mainstream (Farhoomand et al., 2009, p. 7). The company was to revisit this marketing scheme with its PS3 and the inclusion of a Blu-ray player.

The appointment of Iwata in 2002 as a new president for Nintendo marked the dawn of a new era. The new president was to bring new and innovative changes to the company using his years of experience and market knowledgeability (Farhoomand et al., 2009, p. 2). Iwata's strategy was to grow the gaming market to include the non-gamers. In order to accomplish this, he mandated the need for simple games that were enjoyable for all customers (i.e., a fun-for-all game). From the basis of this strategy, spawned Nintendo's DS and Wii gaming systems (Farhoomand et al., 2009, p. 4).

As a means to test his strategy, Iwata and his company, developed the Nintendo DS handheld gaming device to expand the video gaming industry beyond the television. Nintendo was not entirely new to the handheld device market. They had previously introduced the Game Boy in 1989, Super Game Boy in 1994, and the Game Boy Colour in 1998. For the DS, it included many

innovative features such as a touch-screen that allowed gamers to manipulate in-game actions using a stylus pen. In addition, Nintendo introduced Wi-Fi capabilities in subsequent versions of the DS. This allowed users to play competitively or cooperatively together over an existing Wi-Fi network. With the release of the DS Lite, Nintendo continued to maintain its 90% market share in the handheld video gaming industry through sustained innovation (Farhoomand et al., 2009, p. 5). In early 2005, Sony introduced its PlayStation Portable (PSP) as a direct competitor to Nintendo's DS device (Farhoomand et al., 2009, p. 14).

The Nintendo DS not only introduced innovative concepts such as the touch-screen and Wi-Fi capabilities, but it also had many creative gaming titles. Successful games included *Nintendogs*, *Dragon Quest V*, *Guitar Hero: On Tour*, and *Pokemon Mysterious Dungeon 2* (Farhoomand et al., 2009, p. 21). In July 2008, three of these games were amongst the top ten most popular games in the world (Farhoomand et al., 2009, p. 21).

Building on the successes of the Nintendo DS, and with a focus on capturing non-gamers, Nintendo developed the Wii in hopes of recapturing some of its market share in the fixed console market. The Wii was released in 2006, similar to the rollout dates for Microsoft's Xbox 360 and Sony's PS3. Nintendo's newest console had a compact design that relied on the use of an easy-to-use wand-like controller. The controller was innovative in its simplicity, but also in its ability to translate the movements of the wand into in-game action through the use of built-in motion sensors. The Wii also provided the ability for users to connect to the Internet to access the latest news or weather conditions in their region. An open connection to the world also allowed Nintendo to sell some of its classic games that were originally released for the Super NES and N64 systems. These games were available for direct download (Farhoomand et al., 2009, p. 5).

The sales of the Wii skyrocketed upon its release in the United States. Nintendo sold 600,000 units in just the first eight days, which generated approximately \$190M in sales for the company. In June 2008, Nintendo had recorded a total of 10.9 million Wiis sold in the US. This was approximately 500,000 more units than the Xbox 360, which had been released a year prior to the Wii (Farhoomand et al., 2009, p. 10). Figure A.4 provides an overview of the cumulative sales for each

of the three consoles (i.e., Wii, PS3 and Xbox 360) between 2006 to 2008.

The gross profit margin per console was another area where Nintendo was well-positioned. The company was making a profit on each console sold from its original release. In comparison, both Sony and Microsoft were losing money on their consoles upon initial release. Nintendo was turning a profit of approximately \$50 per system, whereas Sony was incurring a loss of over \$300 and Microsoft was losing out on \$125 with the sale of each console (Farhoomand et al., 2009, p. 24). Gross profit margins for each of the consoles are visually compared in Figure A.3.

Similar to Nintendo's success with gaming titles for the DS, the Wii also brought quality games to users. The games were not built around complex graphics that might require expensive hardware, but were built for simplicity and fun for the whole family. Some of the most popular titles included *Wii Sports*, *Wii Fit*, *Mario Kart Wii* and *Super Smash Bros Brawl* (Farhoomand et al., 2009, p. 21). Nintendo's exclusive release of *Super Smash Bros Brawl* for the Wii saw 2.7 million copies being sold in that month alone. During the same month, Nintendo sold more Wii's than PS3 and Xbox 360's combined (Farhoomand et al., 2009, p. 9).

Nintendo has formed several partnerships with other companies on some of its products. For instance, the company formed a design alliance with Silicon Graphics for the release of the Super Game Boy (Farhoomand et al., 2009, p. 13). Also, Nintendo had a short partnership with Sony in the 1990's over the incorporation of CD-ROM in the Super NES; however, differences over the visionary direction led to the two companies parting ways. The Super NES was based on cartridge technology, but through a deal with Philips, an add-on device was available to use optical compact discs with a larger storage capacity (Farhoomand et al., 2009, p. 2).

Figures A.1 and A.2 present the profit margins and gross margins, respectively, for Nintendo, Sony, and Microsoft between the years 2005 and 2008. In Figure A.1, it is clear that both Microsoft and Nintendo's profit margins have been slowly decreasing since 2005, but are still higher than Sony. During the same period Sony experienced a slight increase in profit margins since 2005. In Figure A.2, both Microsoft and Sony experienced considerably greater decreases in gross margin than Nintendo between 2005 and 2008. In the financial assessment of these companies it is

important to recognize that the financials for both Sony and Microsoft include profits from a variety of other products including Sony laptops, Microsoft Office software, and so on. It's difficult to determine from these graphs whether an increase in profit margin or gross margin is directly a result of gaming console sales. For Nintendo, they do not have such a wide variety of products and therefore these graphs are likely accurate in presenting the impact of the Wii on their finances.

### 3 Analysis of Facts

Nintendo's introduction of the DS and Wii gaming systems allowed the company to take an innovative and commanding stance in the video gaming industry. The company's ability to put forward innovative systems helped increase both the quality and quantity of gaming titles being built for the Nintendo platform. In addition, through disruptive innovation, Nintendo was able to target a new market of gamers - the casual or non-gamers. Nintendo essentially created a new playing field for the video gaming industry.

The introduction of Nintendo's innovative handheld device, the DS, in 2004, helped provide a boost to Nintendo's gaming title sales, which likely encouraged developers to adopt the Nintendo platform. Nintendo had a real knack for gaining headway with gamers outside the hardcore category. With the Nintendo DS, and games like *Nintendogs*, Nintendo was targeting new classes of gamers (i.e., families, women, and various different age groups). With the Nintendo Wii, they were able to gain casual customers with games that were fun for the whole family, such as *Wii Sports*.

The importance of having quality games for a particular console becomes evident when the correlation between the launch and sale of games shows a corresponding jump in console sales. For example, when Nintendo launched their exclusive hit game *Super Smash Bros Brawl* for the Wii, they noticed that in the same month they had sold more Wiis than Xbox 360s and PS3s combined. It becomes evident that it is imperative for consoles to not only have a good system, but quality games to accompany it. This will help drive sales and encourage new users to adopt the console (Farhoomand et al., 2009, p. 9).

The Nintendo Wii could be considered a disruptive innovation. As a console, it could not

compete with its competitors the Xbox 360 and PS3 on graphics capabilities, realism and speed (Farhoomand et al., 2009, p. 9). Nintendo's under-performance in these technical criteria didn't impede its ability to regain serious traction in the video gaming industry. The Wii's complete overhaul of the standardized approach to gaming controllers and communicating in-game actions simplified the entire gaming experience, opening up the industry to a broad demographic. The use of motion sensing technologies in the controller provided an entirely new way of experiencing video game playing. Games built around this technology were intuitive, social, and involved active engagement, and included such activities as tennis, bowling and boxing (Farhoomand et al., 2009, p. 5). This allowed Nintendo to target a demographic group that had not been successfully engaged with in the past - the casual gamers.

A key source of value for Nintendo derives from network externalities. In the case of consoles, the network externalities extend to products that are used with the base console. For the Wii, this would include the gaming system's supported gaming titles, and any add-on peripherals (e.g., Wii Balance Board). In the video gaming industry, the greater number of users that buy and use a particular console results in a greater chance that more games will be developed for that system. As more developers are drawn towards a particular console and platform, it increases the value of the entire product for the user in a positive feedback loop. This is known as indirect network externalities (Mohr, Sengupta, & Slater, 2009, p. 20).

Nintendo's focus on the Wii's pricing and affordability also proved to be one of the deciding factors for its success. The fact that the Wii was priced lower than both the Xbox 360 and PS3 stemmed from the realities that its technical abilities were inferior to the other consoles. The technologically advanced and complex Xbox 360 and PS3 systems actually resulted in both Microsoft and Sony losing large amounts of money with each sale (Farhoomand et al., 2009, p. 24). Sony had to slash the price of the PS3 by \$100 in order to compete against Nintendo's upheaval of the market (Farhoomand et al., 2009, p. 10). On the other hand, Nintendo was able to turn a profit of almost \$50 dollars per sale of a console. The affordability of the Wii helped Nintendo regain some of its previously lost market share, and also make significant profits. Figure A.3 provides a

breakdown of the gross profit margins for each of the consoles upon entering the market.

The healthy profit margin per console for Nintendo, in comparison to the other consoles, was clearly advantageous. Due to the losses incurred with each console sold, Microsoft and Sony had to rely on their ability to gather profits from sales of additional accessories and gaming titles. The potential pitfalls and risks to this approach were further amplified by Sony's and Microsoft's reliance on third-party developers for their games. For third-party games, they would only receive a ten to fifteen per cent cut of the selling price (Farhoomand et al., 2009, p. 24). In contrast, Nintendo had a healthy line-up of in-house games, which positively impacted its overall revenues. Nintendo would make all profits from the in-house games. This is one potential avenue Nintendo could continue to explore in order to maximize its profits and continue with its competitiveness.

In addition to Nintendo's in-house gaming capabilities, they also provided a business model that was seemingly conducive to independent software development. WiiWare was an online channel where games could be distributed through the Web, allowing users in US and Europe to access the content. This provided Wii users with access to novel content created by independent developers (Farhoomand et al., 2009, p. 10).

The disruptive nature of Nintendo's Wii targeted more than the casual gamers demographic. It opened the doors to those interested in healthy and active lifestyles, and helped with the re-emersion of "exergaming." Exergaming combined on-screen gameplay with physical exercise. In its earlier packages, dating back to 1989, Nintendo had the Power Pad, which allowed users to jump or step on pressure sensors to play sports games. With the release of the Wii and supporting games such as *Wii Fit* and *Wii Sports*, Nintendo had successfully re-introduced a new generation of "exergaming." The motion sensor technology of the Nintendo Wii's controller encouraged people and families to get on their feet, swing tennis rackets and bats, dance, and even throw bowling balls. The *Wii Fit* title provided users with a plethora of activities, including yoga and push-ups (Farhoomand et al., 2009, p. 10). Iwata's strategy to provide a video game console for the masses was working. This potential market should be further explored and exploited by Nintendo and future versions of the Wii.

Even though Nintendo was able to regain some of its market share by introducing the Wii and exploiting a new market, its major competitors Sony and Microsoft will likely have healthy and competitive appetites for their own slice of this demographic's pie. Nintendo should expect that both Sony and Microsoft will copy aspects of its business model to open doors to this new market. Iwata, and his company, should take their early dominance in the market and build from there, adding incremental improvements and sustaining innovation.

## **4 Solution Development**

The introduction of Nintendo's Wii console was enough to shake up the video gaming industry. In order to maintain this momentum, Nintendo should focus on improving current system performance and other technical features of its Wii system for future releases. By switching gears from its disruptive nature to a more sustaining one, Nintendo will have to find ways to keep those consumers that it attracted in the disruption (i.e., the casual gamers) interested in buying more from the company. While maintaining innovation with the Wii system and the new market that it targeted, Nintendo should continue to experiment with other innovations that target additional markets.

Nintendo is seemingly well-positioned to benefit from continued success in the video gaming industry based on the analysis of facts and the success of both the DS and Wii systems. Moving forward, Nintendo has many considerations to explore before deciding how best to maximize their market share and continue to be profitable.

## **5 Findings and Managerial Recommendations**

Although Nintendo has been successful in regaining a foothold in the video game industry by revolutionizing and changing how games are played and experienced, there are still many areas for improvement. Addressing these areas might better position Nintendo for any oncoming onslaughts from its competitors, who will likely be battling for a share of these new markets.

One possible area of continued improvement for Nintendo is to strongly encourage the development of additional in-house gaming titles. This type of business model is seemingly very profitable

for Nintendo as they receive all earnings from the sale of a game, as opposed to third party titles where only a fraction of the profits are directed to the console owner. Bringing more quality titles to the system will further encourage developers to adopt the Nintendo platform as their platform of choice. Nintendo might also consider additional investments into its WiiWare, which makes software developed by independent parties available in both the US and EU. The company might consider expanding into the Asian markets with this service. As the content available for the Wii system grows, it could further encourage additional users to buy into the system.

Nintendo should continue to build on the successes of the DS and Wii systems, which likely resulted in a significant boost in reputation. With the introduction of family friendly and active games, Nintendo has gained the trust of many households across North America and the World. Nintendo should build on this trust and focus on improving the range of game titles that maximize the potential of the motion sensing technology of the Wii controller, but also building on the exercise and educational capacities for the gaming industry.

Nintendo's management team should consider making additional investments in improving the "exergaming" capabilities of the Wii. The childhood obesity rate in the United States has increased dramatically over the last three decades, which has caused an increased incidence of type 2 diabetes and high blood pressure. The major contributing factor for this rapid growth of childhood obesity is a lack of physical activity (Davies, Fitzgerald, & Mousouli, 2008, p. 228). Given the current trend in childhood obesity, an investment in "exergaming" would likely be a smart investment.

Nintendo's ability to access new markets enabled them to gain a strong stance in the gaming industry. In order to continue with this momentum, and make further gains in the highly competitive market, Nintendo should once again explore setting up partnerships with others in the industry. In support of additional investments to "exergaming," Nintendo should seek out partnerships with health agencies, popular health advocates, large sporting stores, and national sporting bodies (e.g., International Olympic Committee) to design more advanced and clinically proven methods to fight obesity and promote healthier and more active lifestyles for everyone. Nintendo already enjoys success in this market with gaming titles such as *Wii Fit*, which amazingly sold two million copies

in Japan in just six months (Farhoomand et al., 2009, p. 10). Due to the already popular nature of these products, there exists real potential for Nintendo to gain additional market shares and profits.

Nintendo's successes with both the DS and the Wii provides some indication that an effort to join these technologies together into a unified product could potentially reap many rewards. Combining the innovative nature of motion sensor controllers, touch screens, and Wi-Fi capabilities could potentially bring together the best of the console and handheld gaming industries.

Nintendo should also begin to focus on increasing the graphics performance and other hardware-related performance of its systems. Sony and Microsoft have already tackled this with their previous systems, and have this advantage over Nintendo. They are able to create more graphics-heavy games that appeal to hardcore gamers. Nintendo has the potential to regain some footing in this market if it resumes its efforts in increasing overall performance. Partnerships with graphic card industries could potentially be one avenue to explore here. Nintendo will need to be careful that a focus on improving console performance doesn't impact the future price tags for systems, which would take away from its very successful business model of affordability.

Another managerial recommendation for Nintendo would be to continue its move away from the use of overly proprietary and restrictive media technologies, such as the GameCube game discs and the N64 cartridges. Nintendo's competitors, Microsoft and Sony, relied on mainstream media solutions such as CDs, DVDs, and Blu-rays for their media solutions. This allowed Nintendo's competitors to use their systems as a selling point for potential media centers that supported the playback of music from CDs and movies from DVDs. Sony's inclusion of Blu-ray in the PS3 helped the media type become mainstream, and it became one of the key marketing strategies for the company (Wesley & Barczak, 2010, p. 126). Nintendo should take lessons from its competitors with regards to media adoption and usage, and ensure that it sticks with mainstream media types in future products.

Nintendo has clearly presented the world with a new field of gaming, one that has for the moment left its competitors in the cold. However, both Microsoft and Sony have recorded a large number of sales with their respective systems (refer to Figure A.4), and given their market share,

they will likely be returning with direct competitors to Wii in hopes of cracking into these new markets. Nintendo should build on their proven track record for innovation, being first in the casual gamers market, and continue to strive to revolutionize the video gaming industry.

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# Appendices

# A Figures & Tables

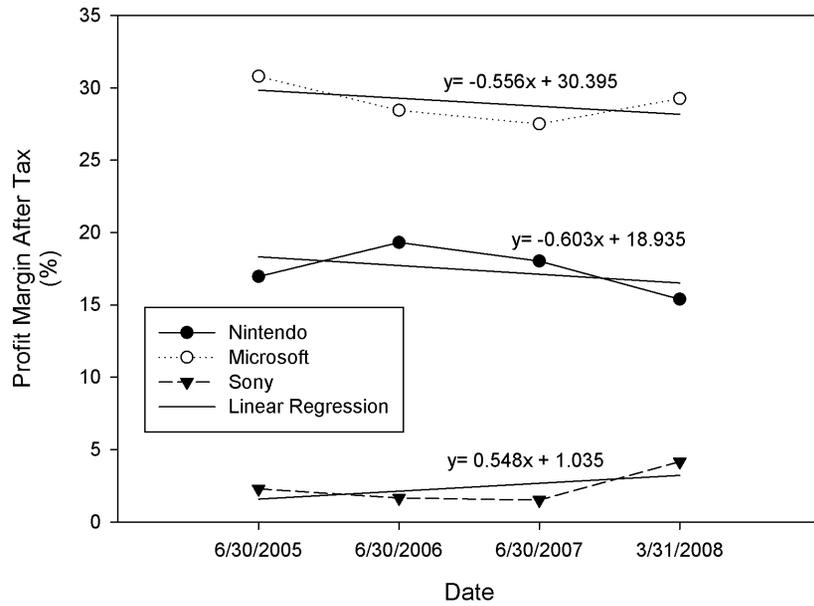


Figure A.1: Profit Margin Trends Between 2005 and 2008

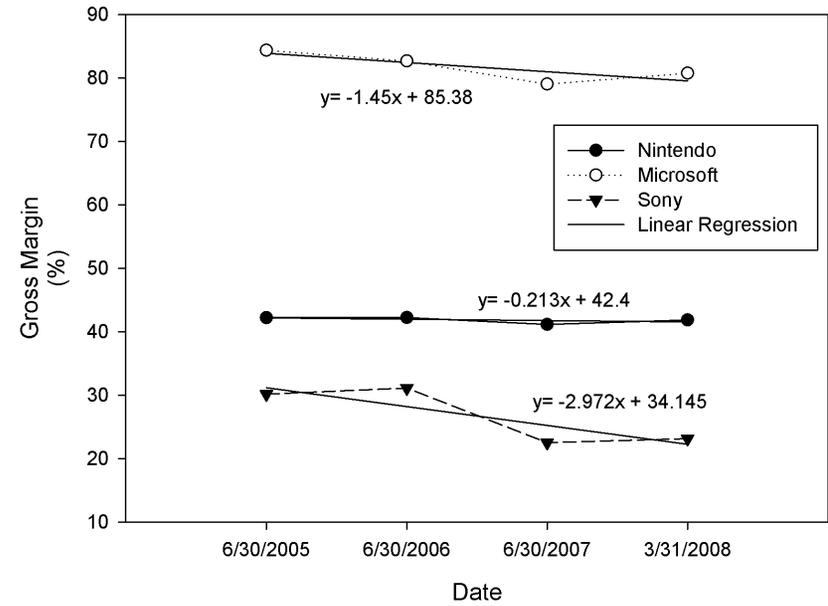
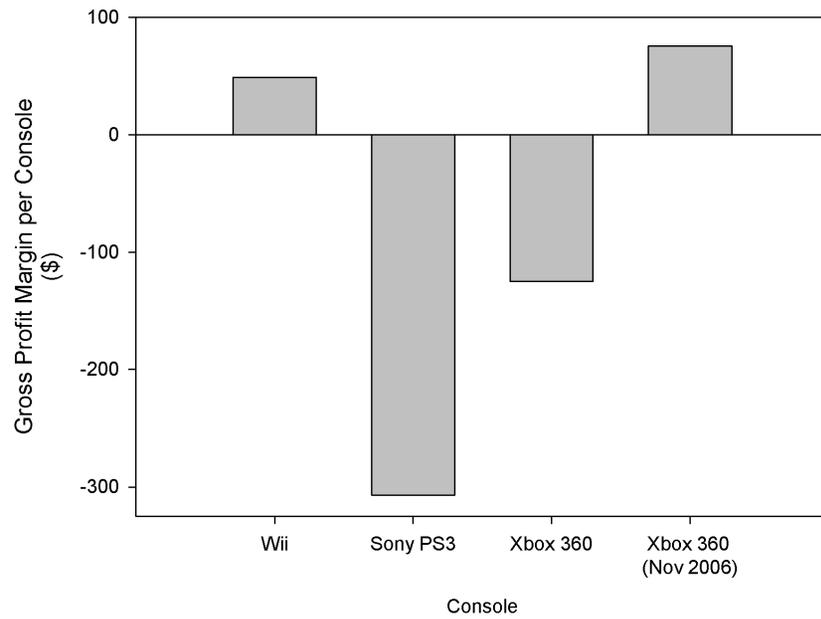
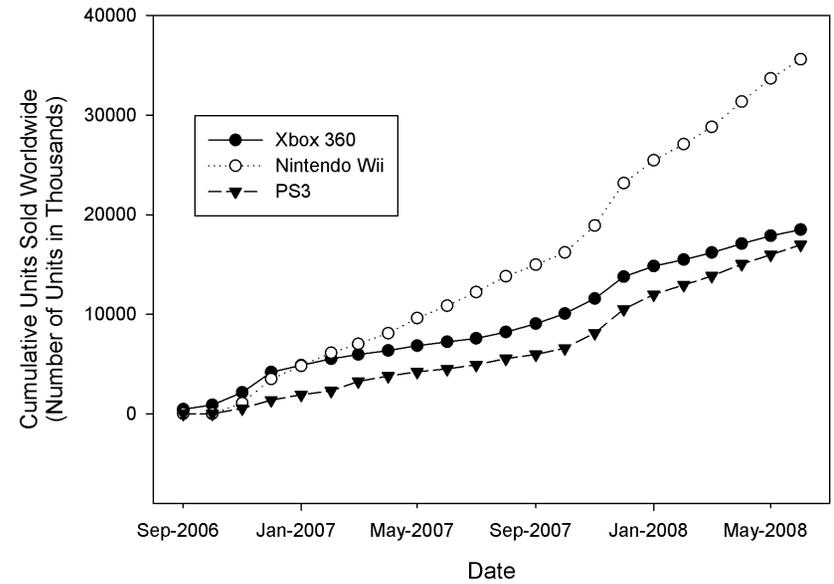


Figure A.2: Gross Margin Trends Between 2005 and 2008



**Figure A.3:** Gross Profit Margin per Console



**Figure A.4:** Cumulative Sales per Console from Sept. 2006 to June 2008