

The End Game: How Top Developers Sold Their Studios

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In November 2002 Angel Studios was purchased by Take Two for \$28 million in cash and 235,000 shares of stock. A month earlier Activision purchased Luxoflux for \$9 million and 110,000 shares of stock. That same year Infogrames (now Atari) purchased Shiny for a surprising \$47 million, and who can forget Microsoft's purchase of Rare for a whopping \$375 million? And the list goes on: Massive Entertainment, Rainbow Studios, Barking Dog, Black Box, Shaba Games, Gray Matter, Treyarch, Outrage, Volition, Digital Anvil, Westwood Studios, and more. All have been purchased by a major publisher and experienced the thrill of the end game.

For many developers, selling their studio is the final prize for a race well run. But what do you really know about how a deal goes down and whether or not you are a good prospect? What is it that will make your studio attractive? How will your company be valued? And perhaps most importantly, what can you do to prepare?

In this two-part series we will discuss the acquisition process as it relates specifically to the game industry. It is based on interviews with key executives from both sides of an acquisition transaction: independent game studios who have been purchased and the publishers who purchased them. Interviews were also conducted with attorneys and investment firms that deal in mergers and acquisitions within the game and software industries. And finally, research was conducted to quantify specific transactions and acquisition details.

In this first segment we will explore the relationship between developers and publishers and the motivations of each to enter into an acquisition. Beginning with a condensed history of game developer acquisitions, which you will find surprisingly informative, we will then look at why developers sell their companies and why publishers are interested in buying them.

In the final part segment, we will then look at how a developer's monetary value is determined, how the deal is put together, and what can go wrong during the acquisition process. We will end the series by considering the future and what the prospects might be like for you to one day play The End Game.

Disclaimer

You should understand that mergers and acquisitions are complex business relationships that require the help of legal and accounting professionals. The information contained in this article is intended to give you a basic overview of this process as it relates specifically to the interactive game business. Neither Dan Lee Rogers nor BizDev, Inc. makes any representation or warranty of any kind, whether expressed or implied, with respect to the accuracy or completeness of the information. All information is provided on an "as is" basis, including, but not limited to, warranties of merchantability, non-infringement, or fitness for any particular use.

Acquisition History in the Game Industry

Much of the information included in the table below was collected from financial data released by publishers as required by the Security and Exchange Commission (SEC). Notwithstanding this, I am thankful for the input provided by numerous individuals as well. Please note that information from non-public sources is speculative and presented only in an atmosphere of more fully understanding the dynamics of the industry.

By overlaying the acquisitions in this table with major industry events (such as the introduction of the PlayStation 2) you can imagine how environmental factors could have affected each transaction. Microsoft's purchase of Rare in September 2002 could be an example of this.

\$375 million dollars in cash (the purchase price of Rare) is the most paid for any developer to date. Although Rare was a proven developer of hit games, it appears to be an unusually large sum for a development studio. However, when you consider environmental factors, such as Microsoft's goal to establish itself as a premium console manufacturer (Xbox), it is more easily understood. Rare not only added positive net income to Microsoft Game Studios, but it helps secure their position in the console market. And if indeed this goal is met, then not only will the acquisition have a positive effect on Microsoft/Rare's future product sales, but on the sales of all Microsoft Xbox products.

DATE	COMPANY	PRODUCTS	ACQUIRING COMPANY	TERMS
1991	Distinctive	4D Boxing, Hardball, Test Drive	Electronic Arts	\$11 million (\$785K in cash)*
1992	Origin	Wing Commander, Ultima	Electronic Arts	\$35 million stock (estimate)*
1992	Westwood	Kyrandia	Virgin	\$5 million value (estimate)*

1994	SONY PLAYSTATION LAUNCHES			
1995	Iguana	Turok	Acclaim	\$5 million cash + undisclosed stock
Oct-95	Sculptured Software	Star Wars, Mortal Kombat, Jack Nicklaus Golf	Acclaim	\$30 million in stock
Oct-95	Probe	Die Hard, Back to the Future, X Men	Acclaim	\$30 million in stock (estimate)*
1995	Papyrus	NASCAR	Sierra	\$40 million stock (approx.)*
1995	Impressions	Ceasar II, Lords of the Realm	Sierra	\$8 million stock (approx.)*
1995	Bullfrog	Populous, Syndicate, Magic Carpet	Electronic Arts	\$25 million (estimate)*
1996	NINTENDO N64 LAUNCHES			
Apr-96	Headgate	PGA Championship Golf	Sierra	\$8-10 million stock*
Sep-96	Mission Studios	Jet Fighter	Take Two	\$1,674,478 cash, 182,923 stock (value \$440,000). Promissory note value
Jun-96	Formgen	Duke Nukem	GT Interactive	1,030,000 shares GT stock
Jul-96	Humongous	Freddie Fish, Putt Putt	GT Interactive	3,458,000 shares GT stock
Dec-96	DMA	Lemmings	Gremlin	£4.2 million
Apr-97	Berkley Systems	You Don't Know Jack	Sierra	\$25 million stock (approx.)
Jul-97	Maxis	Sim City	Electronic Arts	\$125 million value stock
Sep-97	Raven	Soldier of Fortune	Activision	Value 13 million, 1,040,000 shares
Sep-97	Odd World	Abe's Oddysee	GT Interactive	\$7 million (TCI portion) (estimate)
Oct-97	SingleTrac	JetMoto, Twisted Metal, Twisted Metal II and WarHawk	GT Interactive	\$5.4 million in cash and 700,000 shares of stock valued at \$7.2 million, (total value of \$12.6M)
Aug-98	Westwood	Command and Conquer, Lands of Lore	Electronic Arts	\$122.6 million (majority to Westwood)
Sep-98	Crystal Dynamics	Gex, Soul Reaver	Eidos	\$47.5 million US (£28.4)

Dec-98	Talonsoft	Battleground, Art of War	Take Two	1,033,336 shares (accounted as a pooling of interest)
Dec-98	Reflections	Driver, Distruction Derby	GT Interactive	2.28 million shares of common stock
Dec-98	FASA	MechWarrior	Microsoft	Undisclosed
1999	SEGA DREAMCAST LAUNCHES			
Jan-99	Legend	Mission Critical, Death Gate	GT Interactive	\$13.5 million stock
Mar-99	Gremlin	Grand Theft Auto, Realms of the Haunting, Loaded	Infogrames	\$36.8 million cash
Sep-99	DMA (Owned by Infogrames)	Grand Theft Auto, Realms of the Haunting, Loaded	Take Two	\$11 million cash (assumed DMA debt)
Apr-99	Access Software	Links	Microsoft	Undisclosed
May-99	Pacific Coast and Power	Activision	THQ	\$10M in stock (estimate)
Oct-99	Neversoft	AMDK, Tony Hawk Pro Skater	Activision	700,000 shares stock (est. value 10M)
Nov-99	Bungie	Myth	Take Two	\$5 million cash for 19%
2000	SONY PS2 LAUNCHES			
Jun-00	Bungie	Oni, Myth, Halo	Microsoft	Est. value \$20-\$40 million (based on Take Two sale of 19% @ 5M cash, 5.8 sale of Bungie assets)*
Jul-00	Pop Top	Railroad Tycoon II, Tropico	Take Two	559,100 shares (est. value \$5.8M)
Jul-00	LTStudios	Startup with multiplayer concepts	Argonaut	£300K for 30%, 9.5% bond, remaining 70% purchased 9-2001 for a nominal sum
Aug-00	Volition	Freespace, Red Faction	THQ	890,100 shares common stock + 109,900 shares common (options)+ 500K debt assumed (est value \$21.25M)
Oct-00	Just Add Monsters	Kung Fu Chaos	Argonaut	£200,000 cash and 400,000 stock plus a deferred £210,000 in

				Loan Notes
Dec-00	Digital Anvil	Freelancer	Microsoft	Undisclosed
2001	MICROSOFT XBOX LAUNCHES			
Jan-01	Red Zone	NFL Gameday	Sony	Undisclosed
Jan-01	Naughty Dog	Crash Bandicoot, Jak and Daxter	Sony	Undisclosed
Feb-01	Blue Byte	The Settlers	Ubi Soft	Value 13 million Euros (\$8.2 M US)
May-01	Ensemble Studios	Age of Empires	Microsoft	926,077 shares common stock (est. value \$83M)
Jul-01	Red Storm	Rainbow Six	Ubi Soft	\$43 million value
Jan-02	Particle Systems	Powerdrome, SubWar 2050	Argonaut	Â£2.4 million in total plus 3.5M in Argonaut shares
Jan-02	Gray Matter	Return to Castle Wolfenstein	Activision	\$3.2 million in stock
Jan-02	Rainbow Studios	Motocross Madness, Splashdown	THQ	Total value est. \$44.6M (1,287,000 shares of stock plus performance incentives)
Apr-02	42-Bit	Rally Championship 7	Warthog	Value Â£400,000 (in Warthog shares), futher 700K shares based on performance
Mar-02	Shaba Games	Wipeout, Big Hurt Baseball, Magic: The Gathering	Activision	387,932 shares of common stock. Value \$7.4 million
Apr-02	Shiny	MDK, Matrix	Infogrames	\$47 million (31M cash, 16.2 promissory notes)
May-02	Outrage	Decent PC	THQ	Undisclosed
May-02	Z-Axis	Dave Mirra Freestyle BMX	Activision	\$12.5 million in cash and 373,385 shares of stock. Total value \$20.9 million
Jun-02	Black Box	NHL Hits, Need for Speed, Sega Soccer	Electronic Arts	14M rumored value*
Aug-02	Barking Dog	Global Operations, Homeworld: Cataclysm, Treasure Planet	Take Two	\$3 million cash, 242,450 shares restricted stock (total est. value \$9M)
Sep-02	Rare	StarFox, Donkey	Microsoft	Total \$375 million

		Kong		cash, \$100m of which to Nintendo
Oct-02	Luxoflux	True Crime, Vigilante, Streets of LA	Activision	\$9 million cash
Oct-02	Treyarch Invention	Tony Hawk, Spider-Man	Activision	1,228,442 shares common stock. Total value \$18.2 million
Oct-02	Massive Entertainment	Ground Control	Vivendi Universal	Undisclosed
Jan-03	Infinity Ward	Call of Duty	Activision	Undisclosed
Nov-02	Angel Studios	Smuggler's Run, Midnight Club, Red Dead Revolver, Transworld Surf	Take Two	\$28 million cash, 235,679 shares restricted stock (total est. value \$38M)
Dec-02	Zed Two	Pillage	Warthog	£1.5 Million over 3 years, contingent on performance*
2003	Fever Pitch	Starlancer (former Digital Avil developers)	Warthog	Value \$ 300,000 Warthog shares
Sep-03	Pivotal Games	Conflict Desert Storm	SCi	Value £2.4 million (Sci already owned 10%)*

* Information speculative

Why Developers Sell Their Studios

Without surprise, financial security is the most common reason for independent developers to sell their companies. But this should not be confused with a take-the-money-and-run scheme where one sells his company and retires to a beach in the Bahamas. Occasionally a developer will leave shortly after an acquisition, but in general this is not in line with a publisher's expectation. Publishers expect to see a significant return on their investment, and acquisitions are structured to ensure this through the continued participation of key employees.

Many of the developers we spoke with sold their companies out of growing concern for growth and the complexities of working with multiple publishing partners. Generally, their collective motives fell into these categories:

- Concern over growth
- Concern over technology changes
- Leverage marketing and distribution
- Benefits for employees
- Personal growth

Concern Over Growth

Many developers who have sold their studios concluded that a single publisher partner was necessary in order to simplify business relationships and provide long-term financial stability. Also, an underlying concern was that their selling-price was at an all-time high.

As one developer explained, "As your size grows dramatically, projects can get behind and publishers may refuse to pay, some may cancel projects, and others may go out of business. When you're smaller it may be possible to weather these events with personal cash, loans, etc., but as a larger developer a "Perfect Storm" of these events can deliver a really serious blow".

For a developer, sustained growth becomes increasingly complex and risky as the studio grows, since most publishers require non-compete agreements that prevent them from working freely within the industry. To

"As we grew, we were constantly under pressure to deliver a big title every Christmas. I can't talk for the others, but my decision to sell was related to the pressure of keeping everyone employed. If our main product missed Christmas one year, we would have to let 1/2 the employees go. So initially, I was relieved to attach our company to a larger and more stable company."

Richard Garcia, formerly of Papyrus Software

keep teams busy, they often worked with publishers that were less stable financially than themselves. So as their burn rate increased, mistakes and wrong turns were more costly and deadly.

Technology Changes

The transition from one console generation to the next is a powerful catalyst to secure business relationships.

For some, during the transition from PS1 to PS2, their motivation for selling was based on concerns about the implications of technology changes. One developer put it this way: *"The amount of time it took to develop a game was doubling. The amount of people it took was doubling. Hence the cost was going up about five times. And yet the cost of the software was unchanged if not descending. So the risk on each product was going up and the potential profit per person per year was going down. We sold the company partially to mitigate that risk."*

As we move into the next generation of console systems (PS3 and Xbox 2), many developers believe it will be harder and more costly to develop and maintain leading-edge technology. This is especially true when you consider that publishers such as EA and others are investing millions of dollars in technology that can be used throughout their company. In the future, the ability for an independent developer to compete primarily on technology may be more difficult, and this could encourage some to look for secure publishing partners.

Leverage Marketing and Distribution

For other developers, especially in the formative years of the industry, distribution and marketing needs played a significant role in their decision to sell. Papyrus, as example, had built strong development and marketing teams, and initially sold their products through Virgin Interactive (via a 3rd party distribution deal). After Sierra acquired them in 1995, sales and profits increased due to Sierra's strong distribution channel and in-house manufacturing.

Employee Benefits

All of the developers we spoke with were concerned about the long-term welfare of their employees. As a small company, it was challenging to provide the level of health insurance, job security, and retirement benefits offered by publishers. Additionally, since many had distributed stock or options to employees, the liquidity of this benefit was ultimately dependent on an acquisition.

Personal Growth and Achievement

A less tangible but equally compelling reason for selling was the realization of a life-long dream. Most of the individuals we talked with had been in business for several years prior to their acquisition. Selling their company was a benchmark both in self-actualization and industry recognition of their achievements.

Why Publishers Purchase Game Developers

Publicly owned publishing companies have an insatiable appetite for growth and net profits. Each is on a full-time mission to increase their revenue, trim their operational costs, and take the advantage from their competitors. Like a global sports game, they are engaged in a winner take all competition for the hearts and wallets of game consumers. If your company can assist them in this endeavor then you could be an acquisition candidate.

But until a publisher sees material value, there is little chance that you'll find an interested partner. Publishers generally purchase developers for these reasons:

- Development expertise
- Financial growth
- Competitive advantage
- Proprietary technology
- Intellectual property

Development Expertise

Most publishers are interested in working with teams with proven capabilities, and they tend to acquire developers with whom they have worked with in the past. For most, they purchase studios in order to increase or upgrade their development ability, and all the publishers we spoke with agreed that the talent, the culture, and the experience of the team were among the most valuable assets a studio could offer.

Growth

A driving reason for purchasing an independent developer is to increase the publisher's net income. Since a public company's performance is measured by growth and profitability, if, by acquiring your company, they can increase net profits they are rewarded by their stockholders and the Stock Market. The higher the perceived value, the higher their stock price. The higher the stock price, the more money the stockholders will receive.

This point can be illustrated using our previous example of Rare and Microsoft. Prior to its acquisition, Rare had sales averaging 1.4 million units per title, with more than 90 million units sold since the company was founded.ⁱ If we assume that Rare is capable of continuing to deliver 8.4 million dollars annually to Microsoft's bottom line in the future, then this would reflect positively on Microsoft's annual net earnings:

$$\begin{aligned} & \mathbf{1.2 \text{ Million Units Annually (slightly lower than their sales average)}} \\ & \quad \times \mathbf{\$35 \text{ Wholesale Price per Unit}} \\ & \quad \times \mathbf{20\% \text{ (An estimate of profitability per unit)}} \\ & \quad \text{-----} \\ & \mathbf{= \$8.4 \text{ Million Dollars Annually in Net Income}} \end{aligned}$$

For Microsoft, \$8.4 million dollars in additional annual net income is fairly insignificant, but if you consider that their investors value every incremental net income dollar at a multiple of 21.77 times that numberⁱⁱ, it is more meaningful. Loosely defined, this revenue stream is valued by Microsoft shareholders at \$182,868,000 ($21.77 \times \8.4M). While this is still far below the \$375 million that Microsoft paid for Rare, it does help explain how positive net income is valued.

Publishers also grow by opening new markets and genres. For example, although Electronic Arts dominates the sports genre they have little penetration in the 3rd person action genre (*Crash Bandicoot*, *Spyro*, *Ratchet* and *Clank*). If EA believed that they could earn significantly more revenue by competing in this market, it could be motivation to purchase an independent developer that specializes in this genre. The more profitable the developer, the more attractive they would be.

Finally, financial growth can also be obtained by acquiring a team to which a publisher has major financial commitments, most often in the form of on-going royalty payments. Electronic Arts' acquisition of Black Box may fall partially into this category. Black Box was the independent developer responsible for EA's hit series *Need For Speed*, and no doubt, EA was paying Black Box significant royalties as a result.ⁱⁱⁱ By purchasing Black Box, EA recaptured these royalty payments and acquired a proven development team.

Competitive Advantage

It is often advantageous to purchase a developer that has been successfully operating in a space where a publisher is having difficulty. It is even more attractive if by doing so they can take market share from their competitors or make it more difficult for them to compete. Activision's acquisition of Infinity Ward in January 2003 accomplished just this. A significant number of Infinity Ward's staff came from Electronic Arts where they were key developers on the hit product *Medal of Honor*. By acquiring Infinity Ward, Activision not only secured a proven team of specialized developers for their own World War II series, *Call of Duty*, but they also struck a blow to EA.

"Infinity Ward has a very talented team of programmers, designers and artists, many of whom were members of the team that developed Medal of Honor Allied Assault, one of the most acclaimed PC games of last year. We are confident that this studio's development strengths will further establish Activision as a leader in the PC action genre." **Activision Annual Report 2003**

Proprietary Technology

Developers who own technology that publishers perceive as superior are often candidates for acquisition. Such was the case with Luxoflux. Activision was attracted to Luxoflux based appreciably on their cross-platform technology and their ability to bolster Activision's internal development capability.^{iv}

Proprietary technology is attractive to publishers, but it is often weighed against a make-or-buy decision. Electronic Arts, more than any other publisher, is capable of developing highly advanced technology in-house. But if a developer can help them enter a market more quickly, then it can be a catalyst for purchase. Jerry Bowerman, chief operating officer of EA Vancouver, felt strongly that even in light of EA's capabilities, technology was still the key, *"If they don't have a non-compete, and they own the technology, and they shipped a hit, then they are going to get acquired."*

Sierra's purchase of Headgate Studios is an example of this. In 1996, when Headgate was purchased, Sierra was expanding its Front Page Sports line of products. Although Headgate had not yet shipped a game, Sierra believed that Headgate's golf technology would allow them to enter this segment of the sports market more quickly and with less risk. For them, the purchase was justified based on future sales in a genre where they had no prior presence.

Intellectual Property

"A previous deal, to acquire Treyarch, was done for different reasons. Treyarch had developed a popular game based on the Spider-man movie. By acquiring Treyarch, Activision instantly secured the rights to what was to become one of its top-selling games." **Robert Kotick, CEO Activision**

When Electronic Arts purchased assets from Virgin Interactive in 1998 for \$122.6 million dollars, they were interested in the properties created by Westwood Studios, and in particular, the *Command and Conquer* franchise. *Command and Conquer* has been one of the best selling real-time-strategy games of all time, and by adding it to their portfolio, Electronic Arts immediately became a leader in this category.^v While \$122.6 million dollars was sizable, EA could justify it based on forecasted sales of it and other Westwood properties. Ownership of Westwood's IP was a key to the acquisition.

The acquisition of DMA gave Take Two ownership of *Grand Theft Auto* franchise, which proved later to be an incredibly profitable purchase. Sierra's acquisition of Papyrus was based substantially on the license that Papyrus had negotiated with NASCAR. And perhaps the most recent example of an acquisition motivated by a license is that of Shiny by Atari for \$47 million dollars. Atari was keenly interested in acquiring the rights to *The Matrix*, so much so that they took out a loan in order to finance the purchase.^{vi}

Dating and Marriage

Developers often refer to their publisher relationships using the analogy of dating and marriage. One developer told us that when a publisher and developer sign a development agreement for a single product, it is very much like a first date. At this point neither party knows too much about the other. Their attraction is based on what they perceive the other can do for them, and the date can either go well or terribly wrong. If it goes well, then there is likely to be a second date, a third, and perhaps, if the two continue to find each other attractive, marriage (or acquisition). Our developers cautioned young developers to consider every project and relationship a potential marriage. They advised others to "end well" on every project, since one never knows if the relationships forged on one of these "dates" might turn out to be something more permanent.

"I consider a publishing contract with a developer like dating. If things don't go well, either party can break up and walk away. Selling a company is like a marriage. If things don't go well it's very messy when it breaks apart." **Jason Rubin, Naughty Dog**

One of the most significant aspects of an acquisition is the permanence of the relationship. Once an acquisition is completed, it is nearly impossible to unwind the relationship. Borrowing from a well known expression affords us the ability to pass on a bit of wisdom: *What two companies join together is nearly impossible to pull apart.*

Because of this permanence, certain aspects of the relationship should be carefully considered:

- Culture
- Management
- Employees and redundancies
- Location
- Price
- Deal structure and performance incentives

Culture

For both publishers and developers, culture is an important component of the purchase decision. EA's Jerry Bowerman explained it this way, "...we look at culture very carefully. What would happen if we purchased a company that had been in business for years and during that time they never worked on the weekends? Here at EA we do whatever it takes to get a product out on time. So that would cause a lot of problems for both of us."

Not only is the work schedule an important aspect of culture, but issues can include whether employees have private offices or cubicles, whether snacks are free or paid for by the company, whether the Christmas party is small or elaborate, and literally hundreds of other subtle procedures and policies. No matter how insignificant these may be, all contribute to the heart and soul of the developer's culture.

Both parties want to make the transition as easy and painless as possible, since distractions are costly, translating into poorer product and late deliveries. The two must carefully consider the operational procedures of the other and whether their marriage will work. If in the process of an acquisition a publisher destroys a developer's culture, then they end up killing the very thing that they worked so hard to get.

Stuart Moulder, Microsoft's GM agreed. *"Assume that most publishers are purchasing a developer to gain the benefits of the developer's creative talent (rather than just for IP or some other reason). Then a publisher needs to understand the developer's culture, respect it (it's that culture that is at the heart of the developer's success) and its people."*

Management

Independent developers are used to calling their own shots, making decisions quickly, and taking risks in order to grow their companies. For many, the idea of having to report to a "manager" is foreign and troublesome. But, once a developer is acquired they are likely to lose a significant amount of the freedom that they enjoyed as an independent.

For Rainbow Studios, one of the prime attractions to THQ was that Rainbow would be allowed to work autonomously. At the same time, Mark DeSimone (Rainbow President) also knew that Rainbow would be giving up ultimate control, especially in terms of the products they would be allowed to build. But they were reminded that in the process of working as an independent studio, they were dependent on their ability to convince someone other than themselves that their ideas were sound. So things didn't change that much.

Naughty Dog's Jason Rubin has been pleased with the level of autonomy that Sony has allowed them to continue to enjoy. He believes that this has a lot to do with the healthy relationship that Sony and Naughty Dog had established prior to the acquisition. This is what he had to say about life post-acquisition: *"I don't look at my job at Naughty Dog as being any less important. I still try to make the best games possible and I still work just as long and hard at it."*

Once a developer is acquired there are significant changes to policy and procedures that restrict a founder's ability to react to market conditions. And this can be an issue that is surprisingly tough to swallow. One of the worse things an independent developer can do is to give up control of their company on paper but not emotionally.

Employees and Redundancies

An independent developer's employees are its most valuable assets. How they are treated, how their stock options are dealt with, how their health and retirement benefits are considered are sensitive issues to be discussed during the negotiation.

Because retention is an important issue for both the buyer and seller, key employees are often offered performance and retention incentives as part of the purchase. Who pays for these programs is decided in the negotiation,

"After the sale, I was really surprised that Sierra wanted to make changes with our company. As the former management of the company, we felt we already knew how to run the company and only wanted to be held accountable for results, not process. Our main fight was over the control of marketing, but the whole ordeal turned off management. So we slowly gave up, stopped caring and stopped fighting change. After that, it is only a matter of time before we left." **Richard Garcia, former Papyrus Software**

but clearly both parties know that retaining know-how is critically important.

While retention is critical to the success of a merger, it makes little sense for a publisher to retain a developer's employees in areas where the publisher has established leadership. A developer's sales, marketing, accounting and finance, and IT employees are often made redundant soon after an acquisition.

Location

Publishers know that creativity is closely tied to the developer's work environment. As a result, many developers continue operating from their same office after the acquisition, their lease or property being transferred to the publisher. However, it is important to understand that once an acquisition is complete a publisher has the authority to move or shut down any facility they own (unless there is a contractual obligation in place to prevent it).

EA's move of Westwood Studios in early 2003 is an example of this. Prior to the acquisition, Westwood (Virgin) had invested in a new, 50,000 square foot building in Las Vegas. The building included motion capture facilities, comfortable offices, and was a showcase not only for the game industry but for Las Vegas as well.

After the acquisition Westwood continued to operate from this facility, but in 2003, EA closed it and relocated key employees to Los Angeles, where they were consolidating operations with other west-coast studios. While this has surely been an adjustment for Westwood's employees, they along with other LA-based EA teams will enjoy a new 250,000 foot campus in Playa Vista.

"Microsoft Corp. has agreed to acquire Ensemble Studios Inc., the Dallas-based games developer responsible for the top-selling Age of Empires game franchise. Microsoft said Ensemble will continue to create titles from its Dallas headquarters. Other terms were not disclosed." **Puget Sound Business Journal 2001**

Employees at Bungie may have faced a similar experience. After their acquisition by Microsoft in 1999, Microsoft opened Bungie West in Seattle, relocating many long-time Chicago natives there.

Price

Surprisingly, price is one of the easier issues for the parties to agree on. It is made easier primarily because both parties employ attorneys and accounting professionals who have standardized methods for assigning value to a developer's assets.

David Lee, a partner at the law firm White & Lee in Silicon Valley explained. *"One of the things we do is to help sellers determine a valuation that is justifiable. Obviously we want them to get the highest price possible. We also want to make sure that they have a clear understanding and expectation of what life will be like in the new company."*

In order to define a fair price it is important to understand the basic concepts of valuation, which are detailed in the next section.

Deal Structure and Performance Incentives

The implications of mergers and acquisitions are highly complex. Seasoned tax attorneys and accountants expend significant amounts of energy and expertise to understand the financial impact that an acquisition will have on the parties. The information included below is a generalization intended only to help you understand the basic concepts and structures.

How a deal is structured, and in particular, the tax implications for both the buyer and seller, are key issues. As with all acquisitions, the parties must decide whether to structure their deal as an asset sale, stock sale, whether it will be a tax-free or taxable transaction. Whenever possible, the parties try to maximize the overall benefits and minimize the tax implications. Generally, buyers prefer to purchase assets and to leave the developer's liabilities behind. But what developers need to keep in mind is that as a seller of assets, they are taxed on the gain. As a result, sellers (developers) prefer to sell their stock (rather than assets) and rid themselves of their liabilities.

Cash Only. Regardless of how the deal is structured, a buyer may want to fund the acquisition with cash, their own stock, or a combination of both. In the case of Rare, public records show that the acquisition was a cash sale whereupon Rare received \$275 million from Microsoft (Nintendo was paid another \$100 million).

Stock Only. In other deals, a developer may not get any cash up front. Such was the case with Headgate Studios, which was purchased by Sierra in 1996. In this deal, Headgate was given an undisclosed amount of restricted stock, which prevented Headgate from selling for a certain period of time. Obviously, there was less liquidity with restricted stock, but Headgate evaluated the risk and determined that market conditions were favorable for this type of a transaction. And it paid off. Shortly after the acquisition, Sierra was sold to CUC and Headgate's restrictions were lifted.

For George Metos of Sculptured Software, in a similarly structured acquisition by Acclaim, things seemed to go in the opposite direction. Sculptured was purchased by Acclaim in October 1995, and shortly after the acquisition Acclaim restated their income. Naturally, the stock price dropped significantly. Sculptured was able to re-negotiate and came out okay in the end-but there were scary moments in between.

Cash and Stock. Many deals are a combination of cash and unrestricted or restricted stock. The acquisition of Angel Studios by Take Two in November 2002 is a good example. In this deal, Take Two gave Angel Studios \$28 million in cash and 235,679 shares of restricted stock. The total value of the deal was \$38 million.

The acquisition of Barking Dog by Take Two in August 2002 was similar. In this deal, Take Two paid Barking Dog \$3 million in cash and 242,450 shares of restricted stock.

Debt Assumption. A publisher may also assume the debts of a developer, as was the case with Volition when they were purchased by THQ in August 2000. In this deal, Volition was given 890,100 shares common stock, 109,900 shares common stock (in the form of options), and THQ assumed \$500,000 in debt incurred by the company.^{vii}

Incentives

Publishers often build incentives into deals that translate into additional income based on future performance by the studio. This mechanism is especially useful when the price difference between what a publisher is willing to pay is a significantly less than what the developer is asking.

As an example, if our fictitious developer, PlayWare, Inc. has an asking price of \$20 million and a significant amount of this is based on anticipated net sales, then a publisher may respond with a counter-offer, saying, *"We'll give you ten million dollars now, and if you hit that sales number, we'll give you the other \$10 million that you are asking for."*

"As part of the original acquisition agreement, approximately 360,000 additional shares of our common stock could also be issued to Treyarch's equity holders and employees over the course of several years, depending on the satisfaction of certain product performance requirements and other criteria."
Activision 2003 Annual Report

Performance incentives were used in Activision's acquisition of Luxoflux in October 2002. In this deal, Luxoflux was purchased for \$9.0 million in cash, but the terms also specified that an additional 165,000 shares of Activision stock could be issued to Luxoflux equity holders and

employees over several years, depending on the "satisfaction of certain product performance requirements and other criteria." ^{viii}

Conclusion To Part 1

Acquisitions move silently beneath the waves of our industry. While finalizing this article Electronic Arts announced the acquisition of *NBA Street Series* creator NuFX. The announcement comes as no surprise to industry insiders because NuFX is a proven hit maker and its relationship with EA has been forged over time. Yet it is likely that both parties evaluated the opportunity based on criteria described in this article. And in the end they concluded that an acquisition was in their best interest.

But the process of determining a price for NuFX was an additional effort similar to what will be described in detail in our concluding segment. In this final article we will discuss many of the technical aspects of a developer acquisition, including valuation and the specific activities that both parties undergo during the process.

Stay tuned.

ⁱ Rare, founded in 1985, grabbed the attention of the game world in 1994 with its creation of 'Donkey Kong Country'. The game became the biggest-selling 16-bit title in history. Rare has since become one of the premiere developers in the world, with sales averaging 1.4 million units per title and nearly 90 million games sold since the company was founded. Five of its top 20 all-time-best-selling N64 titles include 'GoldenEye 007', the second-best-selling game in North America, with worldwide sales topping eight million. Junipermedia, 2004.

ⁱⁱ 21.77 was Microsoft's forward P/E ratio in early February 2004. It is used here as an example only.

ⁱⁱⁱ On January 27, 2004 Reuters reported that Need for Speed Underground had already sold 5.5 million units, and was the top selling EA product during the holiday 2003 season. While NFS Underground was developed by Black Box as a wholly owned EA company, one can assume that had the acquisition not occurred, EA would have paid Black Box sizable royalties for this product.

^{iv} Activision's Quarterly Report, November, 2003: "... we have also continued our focus on establishing and maintaining relationships with talented and experienced software development teams. During fiscal 2003, we bolstered our internal development

capabilities with the acquisitions of two privately-held interactive software development companies, Z-Axis and Luxoflux."

^v February, 11 2003 Electronic Arts Press Release: "The Command & Conquer line of games is one of the most popular franchises in gaming history. To date, the franchise has sold more than 21 million units worldwide on multiple platforms, and the series has landed in several editions of the Guinness Book of World Records as the best-selling computer strategy game series of all time."

^{vi} Atari's 2003 annual report notes in connection with the Shiny Acquisition, the Company obtained a \$50.0 million medium-term loan from Infogrames SA.

^{vii} 05.09.2000 THQ Inc. (NASDAQ NMS: THQI) announced that it had acquired revolutionary game developer Volition, Inc. As consideration for the transaction THQ issued approximately 890,100 shares of common stock, assumed existing Volition stock options providing for the future issuance of approximately 109,900 shares of THQ common stock, and assumed approximately \$500,000 in net liabilities. The acquisition was consummated on August 31, 2000 and will be accounted for as a pooling of interests.

^{viii} Activision 2003 Annual Report.

End Notes

The End Game: 2005 Acquisition Activity Update

By *Dan Lee Rogers*

Gamasutra

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URL: http://www.gamasutra.com/features/20050225/rogers_01.shtml

Last year, we concluded a comprehensive study of the most prominent independent developer acquisitions of the last decade, discussing the motivations for both publishers and developers to enter into an acquisition, and including advice from a number of industry professionals regarding this topic. That article is still [available on Gamasutra](#).

This year, in concert with the Game Developers Conference seminar [Where Are You Going with Your Studio](#), we have updated this base of information to include acquisition activity in 2004.

What is New?

Just as it has been a foremost goal in the past, this year a number of prominent independent developers sold their studios to major industry publishers. They sold for many of the same reasons that past developers sold their companies: concern over growth in a changing development business environment, concern over technology changes and the impact of next-generation hardware, a more stable investment future, and liquidity.

For publishers, acquisitions in 2004 appear to reflect a more strategic view of their competitive environment and their anticipated ability to compete in a next-generation-console world. In keeping with historic acquisitions, however, publishers continue to select development partners that they perceive as having strategically superior technology, valuable intellectual property, and reputations as being best-of-class. Publishers have continued the trend of building their internal studio capability in order to maximize control and quality, and lower costs. Whether they will achieve these goals is yet to be determined. Nevertheless, this too has affected the independent development community.

In a consolidation trend similar to what we have experienced on the publisher side, larger independents are consuming more of the open, available projects, making it difficult for smaller developers to compete, both technologically and financially. As profits tighten for all developers, a greater number are interested in finding shelter beneath the roof of a stable purchasing partner.

Whether intentional or not, publishers continue to exert their experience and

"With the amount of money needed to compete in this business, the challenges for the external development community are going to get more intense than ever before. The likelihood of recouping with a development budget in excess of \$10 million dollars is going to be quite challenging."

**- Michael Pole, Vivendi Universal,
on Vivendi's exclusive deal with
Radical**

financial leverage over independents, and as a result, royalty-based development agreements have become even more constrictive and demanding. Many independents have come to the conclusion that actual royalties beyond their development advance are an illusion. This is accentuated when substantially high third-party licensing fees are deducted before a developer's royalties are calculated. (See "The Bottom Line on Licensing", Game Developers Conference 2005).

Independent developers are also facing increasingly higher overhead as a function of bigger, more complex projects. Because next generation games will require even higher head-counts and fixed costs, we believe that developers will be motivated to seek shelter through an acquisition, such as what was experienced during the transition between the PlayStation 1 and the PlayStation 2.

Also appearing more frequently are long-term publishing agreements, similar to the exclusive, six-title agreement signed between Radical and Vivendi last year. While the financial terms of the that deal were not disclosed, Vivendi reported that in addition to Radical's development commitment, they also secured a royalty-free right to Radical's proprietary technology and hold an exclusive right of acquisition during the term. I maintain that while this may have been Radical's best option at the time, the deal may ultimately favor Vivendi. Essentially, Vivendi appears to have acquired Radical's assets and exclusive attention without the sizable investment usually associated with the sale of a two-hundred person development company.

Activision and Take Two have struck similar deals. Over the past few years, Activision has signed long-term publishing agreements with Stainless Steel Studios, Spark, and Lionhead Studios. Likewise, in January 2005 Take Two announced a long-term publishing agreement with Sid Meier's Firaxis.

In the future, other publishers may look for long-term agreements with those who either do not want to be purchased or those who are willing to give up the prospect of an outright acquisition tomorrow in exchange for a more stable future today.

Date	Developer	Products	Publisher	Notes
3/1/2004	Wolfpack	Shadowbane - MMO	Ubisoft	Undisclosed
3/1/2004	Mobius	Max Payne GBA, High Heat Baseball GBA	Take Two	\$4.5 million, of which \$3.6 million was paid in cash, \$920K due in March 2005. T2 recognized identifiable intangibles of \$960K (non-competition agreements) and goodwill of 4.6 million. \$2 million more based on delivery of products.
3/4/2004	IO Interactive	Freedom Fighters, Hitman	Eidos	£36 million (\$68 million) in cash and stock, along with a payment of up to £5 million linked to the four year performance of the studio.
3/9/2004	Surreal Software	The Suffering	Midway	All-stock transaction: 540,317 common shares with an additional

				137,199 restricted shares issued to key employees.
4/29/2004	Relic	Homeworld, Warhammer: Dawn Of War	THQ	\$6 million in cash and \$4 million over the next two years.
8/9/2004	Criterion	Burnout, Renderware	Electronic Arts	According to a 10-Q form filed with the SEC, Electronic Arts spent somewhere in the range of \$48 million to buy Criterion Studios.
8/9/2004	ARUSH	Hunting Unlimited	Hip Interactive	871,312 common shares of which 55,607 are being held in escrow for a period of up to one year. Under the terms of the escrow agreement, the principal shareholder of ARUSH is entitled to purchase the escrowed shares from Hip at a price of \$1.50 per share.
8/11/2004	Monolith	Tron 2.0, No One Lives Forever, Aliens vs. Predator 2	Warner Brothers	Undisclosed
8/26/2004	Inevitable	The Hobbit, Defender, Tribes: Aerial Assault	Midway	All-stock transaction: 218,421 common shares with an additional 152,824 restricted shares issued to key employees.
9/1/2004	Venom	Rocky Boxing	Take Two	\$1.2 million in cash, recording identifiable intangibles of \$750K and goodwill of \$620K
11/16/2004	Digital Illusions	Battlefield 1942	Electronic Arts	EA now controls approximately 67.3% of DICE, and all the 2,329,102 outstanding company warrants.
12/1/2004	Paradox	Mortal Kombat, Backyard Wrestling	Midway	All-stock transaction: 333,334 Midway common shares, with 261,906 restricted shares issued by key employees.
12/4/2005	Indie Built	Microsoft's former sports team, Top Spin, Links, Amped	Take Two	\$18.5 million in cash, recording \$5.8 million in identifiable intangible assets, \$11.5 million of goodwill, \$280K of fixed assets, and \$820K of accounts receivable.
1/20/2005	Vicarious Visions	Shrek 2, Spider-Man 2 DS, PSP	Activision	Undisclosed

1/25/2005	Visual Concepts / Kush Games	ESPN 2K sports	Take Two	\$24 million in cash with rights to all intellectual property associated with the sports titles, as well as rights to the 2K brand.
Developer Acquisitions				

It Only Takes One

In March of 2004, *Freedom Fighters* and *Hitman* creator IO Interactive, was purchased by Eidos for £42 million (\$80 million), proving that it only takes one hit to initiate an acquisition. While *Hitman 2: Silent Assassin* sold in excess of 1.5 million units and generated over \$60 million dollars in gross retail sales, prior *Hitman* games were not as successful. In 2000, IO's *Hitman: Codename 47* for the PC generated approximately \$7 million dollars in gross revenue and sold fewer than 300,000 units in the US. Reviews reflected this. Game Rankings scores for *Hitman: Codename 47* averaged 71%, which is seldom enough to get a publisher's attention.

"The relationship and experience we have already shared over the past five years gives us great confidence in their ability not only to maintain the outstanding success of Hitman, but also to develop new titles of unique IP."

- Mike McGarvey, CEO of Eidos, about the purchase of IO Interactive

Codename 47 for the PC generated approximately \$7 million dollars in gross revenue and sold fewer than 300,000 units in the US. Reviews reflected this. Game Rankings scores for *Hitman: Codename 47* averaged 71%, which is seldom enough to get a publisher's attention.

But *Hitman 2: Silent Assassin* was different. First, it was released across all console platforms (including the PC). Second, the quality improved significantly, with Game Rankings scores averaging 85%. It also appears that IO's technology or process had taken a substantially favorable turn. *Freedom Fighters*, being developed at the time for EA, obtained similar review scores, averaging 82%. It is reasonable to assume that Eidos was at least partially motivated to acquire IO in order to protect its investment in *Hitman* and IO. At £42 million (\$80 million), Eidos' purchase of this 137-person development team was one of the largest of 2004.

Midway Makes Surreal Acquisitions

In March 2004, Midway began a shopping spree that would last through out the year. First, Midway purchased *The Suffering* and *Drakan* developer Surreal Software in an all-stock transaction worth approximately \$6.5 million dollars. Then in August, Midway acquired Inevitable, creator of the latest *Defender* update and Sierra's *The Hobbit* in another all-stock transaction worth approximately \$3.7 million dollars. Finally, in December Midway purchased LA-based Paradox, developers of *Mortal Kombat* and other fighting games, for approximately \$6 million dollars.

The Midway all-stock proposals hit pay-dirt with these three developers, no doubt leveraging a promise of better days under new management and Sumner Redstone's financial umbrella. In each transaction, Midway also issued restricted stock to key employees. It is likely that this was designed to retain these individuals during this formative time.

It is important to note that in an all-stock transaction, the value of the deal at the time a developer is able to liquidate can be significantly different than the value of

the stock at the time of acquisition. We discussed this in "The End Game 2004" with Sculptured Software. Sculptured was acquired by Acclaim in 1995 in an all-stock transaction, and shortly thereafter Acclaim restated their income. The stock price dropped significantly, and Sculptured was suddenly committed to a substantially less favorable deal. Fortunately, they were able to re-negotiate, but for a time their profits had nearly vaporized.

Over the past two years, Midway's stock has grown considerably, starting in January 2004 at \$4.27, rising to a high of \$12.47 in August of the same year, and then falling to the current price of \$9.32 (January 2005). The financial affect on Midway's new studios has been mixed. Surreal's shares are worth approximately \$1.2 million dollars more than when their company was acquired. But Inevitable's shares are worth \$1.0 million dollars less. Nevertheless, both companies could realize significant profits if Midway's stock continues to grow.

Electronic Arts' Key Acquisitions

EA made two significant acquisitions or majority holdings in 2004. The first was expected-the second was not.

Predictably, EA completed its majority holding of Digital Illusions in November, acquiring 48% more of the company. Combining this with their initial 19% investment in 2003, EA now has controlling interest, owning approximately 67.3%, although it does not own the entire company. It also controls 2,329,102 outstanding warrants.

When purchasing independent developers, EA continues to demonstrate that it was most interested in those with both technology and enduring brands. A senior EA executive revealed that the Digital Illusions purchase was driven by a winning combination of network-centric technology and the *Battlefield 1942* brand.

"Criterion is a great cultural fit with EA. We've had a great relationship working on Burnout 3 the past year. The talent, the intellectual property and the middleware technology all combine to make this an acquisition EA is really excited about and further readies us on the next generation of hardware."

- Trudy Muller, EA

What was more surprising was EA's acquisition of Criterion in August 2004. Criterion, the creator of the *Burnout* racing series, is known equally well for its middleware solution Renderware. In a deal that was valued at \$48 million dollars, EA purchased both. It is important to note that *Burnout* was first published by Acclaim in 2001, and review scores at that time were averaging 78%. In its next release, *Burnout 2* improved significantly, with average Game Ranking scores of 85%. But EA's timing was flawless. Capitalizing on Acclaim's decline last year, EA acquired both the developer and the franchise. They released *Burnout 3* over the holiday and achieved Game Ranking review averages of 93%.

EA reports that it will use Renderware as a basis for its next generation platforms, but in doing so some industry executives are concerned that this may compromise Criterion's ability to sell it as a middleware solution. At least one publisher we talked with felt that their future use of Renderware was in question.

Take Two Takes Three

Cash-rich Take Two's activity reflected a key initiative to compete in the sports genre. In 2004, they completed three acquisitions. In March, they acquired portable developer Mobius for \$4.5 million dollars, \$3.6 million of which was in cash. Prior to the acquisition, Mobius had developed *Max Payne GBA* for them, and in what may have been an early signal of their interest in sports, 3DO's *High Heat Baseball* for the PS2.

In a second transaction, in September 2004 Take Two acquired United Kingdom developer Venom for \$1.2 million dollars. Founded by former Rage employees, Venom emerged from Rage's receivership with the rights and technology to *Rocky*, a boxing game that had moderate success on the PlayStation 2 and Gamecube.

In December 2004, Take Two acquired Microsoft's Salt Lake City sports development team, Indie Built for \$18.5 million in cash. Indie was the developer of Microsoft's *Amped*, *Top Spin*, and *Links Golf* games.

Still reeling from EA's exclusive NFL deal¹, in January 2005 Take Two exercised their option to purchase Sega's *ESPN* sports developer Visual Concepts for \$24 million in cash.

Furthermore, they secured exclusive third-party rights to the Major League Baseball license for an undisclosed amount.

Also, in January 2005, Take Two signed a long term publishing deal with Sid Meier and Firaxis, giving them certain rights to the *Civilization* franchise.

"We were very impressed with the Mobius development team from the time they began work on the Game Boy Advance version of Max Payne. They bring a uniquely progressive vision to the titles they develop and we believe this studio is ahead of the industry on next generation handheld development. We are proud to have them join the Rockstar family."

**- Sam Houser, President of
Rockstar Games**

Activision's Investment Avoids Extreme

In 2002, in a move to accelerate its O2 extreme sports brand, within a twelve-month period Activision purchased Grey Matter, Shaba, Z-Axis, Luxoflux, and Treyarch. Unfortunately, outside of *Tony Hawk*, Activision's O2 brand failed to generate notable sales. *Wakeboarding Unleashed*, developed by Shaba, did not sell well. And *Kelly Slater Pro Surfer*, developed by Treyarch, also didn't set the world on fire. Activision dissolved the O2 brand almost as quickly as it was started, and then set about finding development projects for these new internal studios.

Fortunately, the latter part of 2004 was profitable for Activision, with *Spider-Man*, *Tony Hawk's Underground*, and *Call of Duty* all selling extremely well. In January 2005, Activision announced the acquisition of well-known Game Boy, console and middleware developer Vicarious Visions. Prior to the acquisition, Vicarious had maintained a strong relationship with Activision, developing *Spider-Man 2* for the Nintendo DS and PSP, Id's *Doom 3* for the Xbox²; and *Shark Tale*, *Shrek 2*, and *Tony Hawk Underground* for the GBA. The 100-person studio has also developed other hit handheld games, including *Crash Bandicoot*, *SpongeBob Square Pants*, and *Star*

Wars. Terms of the deal were not disclosed, but Activision cited Vicarious Vision's proprietary Alchemy(TM) middleware technology as an opportunity to enhance their next-generation development capabilities.

Other Activity

In March 2004, Ubisoft acquired Shadowbane developer Wolfpack, citing Wolfpack's massively multi-player technology as a primary motive. Later that year, EA would surprise everyone by acquiring nearly twenty-percent of Ubisoft for approximately \$90 million dollars. Ubisoft reported that EA's purchase was unsolicited and hostile. Ubisoft employs over two-thousand workers and posted sales of \$618.9 million in 2004

In April 2004, THQ purchased *Homeworld* developer Relic for approximately \$10 million dollars in cash. Relic's sixty-plus person enterprise recently finished developing *Warhammer 40,000: Dawn of War*.

In August 2004, Warner Brothers acquired Seattle developer Monolith in a move to protect its investment in *The Matrix Online*. It is noteworthy to mention that prior to his involvement at Warner Brothers, Jason Hall (Senior Vice President of Interactive at Warner Brothers) was a co-founder of Monolith. Terms of the Monolith acquisition were not disclosed.

Also in August 2004, Hip Interactive acquired *Hunting Unlimited* and *Playboy Mansion* developer ARUSH for 871,312 shares of common stock. This follows Hip's acquisition last year of French developer-publisher LSP for \$3.8 million dollars.

Outlook

As we move closer toward the release of next generation consoles, industry consolidation will inevitably make it more difficult for new independent development teams to break into the industry, especially when you consider the sizable investment in tools, technology, and reputation that is now required.

As a result, successful independents such as BioWare, Backbone, Zipper, Blue Shift, High Voltage, Climax, Krome, and a handful of others are already finding themselves in high demand, both for new projects and as acquisition candidates.

As mentioned at the start of this article, consolidation on the developer side of the business will be more common, with mega-developers looking to outsource certain aspects of their projects or to acquire a particular expertise in order to control costs and to respond to opportunities not available to smaller studios.

The acquisition prospects for these studios should grow as budgets for next generation games continue to rise (with street estimates for PS3 games forecasted at between \$7 to \$25 million dollars). As publishers are required to invest more in a

Relic and Rainbow

Note the differences in the acquisition price of Relic and Rainbow. For both, goodwill (substantially the difference between actual physical value and perceived value) accounts for the majority of the sale price (88% for Relic and 91% for Rainbow).

At the time of its acquisition, Rainbow had over 100 employees and developed substantially for the PS2 and Xbox, whereas at the time of its purchase, Relic had approximately 60 employees and developed substantially for the PC.

Relic Valuation as reported in THQ's 8K report, November 2004

Estimated Fair Value (in thousands)	
Cash acquired	255
Tangible assets acquired	292
Intangible assets acquired	1,092
Liabilities assumed	(440)
Goodwill	9,016
Purchase Price	10,215

Rainbow Valuation, as reported in THQ's 10K report 2002

On December 21, 2001, THQ issued approximately 1,287,000 shares of common stock and assumed approximately 159,000 stock options as part of the purchase price of Rainbow Multimedia Group, Inc. The issuance increased common stock and additional paid-in-capital by \$13,000 and \$48.6 million respectively, and was allocated among the assets acquired.

Estimated Fair Value (in thousands)	
Cash acquired	N/A
Tangible assets acquired	5,838
Intangible assets acquired	3,531
Liabilities assumed	(5,411)
Goodwill	44,972
Purchase Price	48,930

game or brand, they may look to acquire successful developers in order to mitigate their investment risks and to increase their stock value. Midway's all-stock transactions this past year may be an indication of what is to come with others, especially for those publishers who are without sufficient cash but requiring development expertise for the next generation.

As mega-developers are acquired, contrary to intuition, the effect could actually create fewer new opportunities for independent developers, especially if publishers continue their current trend of investing more money in fewer projects.

Acquisition values in 2004 appeared to be smaller than those of 2003. If developers continue to see publishers as their only means of liquidation, and as publishers spend more cash on licenses and development investments³, all-stock transactions such as those offered in 2004 by Midway may be more common.

For independent developers who are able to hold on during this transition time, they could find themselves in high demand and able to command a premium acquisition price. For those who are highly leveraged, of mediocre quality, and maintaining substantial burn rates, this time could be difficult, since the law of the jungle tends to prevail, with the stronger getting stronger and the weaker falling away.

¹ After competing head-on with Visual Concepts' impressive *NFL 2K5*, on December 13, 2004, EA announced that it had signed an exclusive, five-year agreement with the National Football League. This exclusive license essentially cut off any hope of another developer competing in this genre. Following this, EA signed a 15-year exclusive licensing deal with ESPN, beginning in 2006.

² EA has a publishing agreement with Activision.

³ EA's NFL license reported unofficially at more than \$300 million. EA's ESPN license reported unofficially at over \$850 million. Financial details of Take Two's MLB license were not disclosed.

End Notes