Exploring strategies in online game industry

The factors affect strategy formulation in Chinese online game companies

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Summary

The rapid growth of online game business in China arouses authors’ interest to explore the strategies being used most in the Chinese online game industry and to analyze the factors implicated in these strategies. The theory framework focuses on the internal and external factors that could influence the strategy formulation process. With the models: PEST, Porter’s Five Forces and industry life cycle, the external factors are explored. The recourse based-view, Generic Strategy and SWOT analysis provide the internal examination tool.

In a qualitative approach, the empirical data was collected through online video interviews with the middle level managers in three Chinese online game companies. These empirical data were gathered through the web pages and research reports that were published online.

Findings of this study show diversification strategies, and cooperation or acquisition strategies are used by major online game companies in China. Although these strategies are distinct, the factors that influence strategy formulation are common to a great extent. External factors, such as market need and technology, influence these strategy-making process the most. This study also shows that it is hard to achieve cost leadership in this industry for various reasons.
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1. Introduction

Broadband access, along with recent advances in digital compression technologies, is leading to entirely new, media-rich forms of online entertainment, many of which incorporate interactivity (Deal, 2005). These new rising leisure activities attract people seeking entertainment online and who spend less time with the traditional media. To meet this need, some new industries, such as the online gaming industry, have been born.

Online gaming has been one of the fastest growing businesses over the last few years on the Internet. Since 2003, the market size of the online gaming in the world has been increasing at a rate of over 30% each year (iResearch, 2008). Some well-known multiplayer games, like “Warcraft” or “Ever quest”, attract many gamers and have an increasing number of players. In the past decade, due to the development in personal computers and the remarkable penetration of the high-speed Internet, the business of online games has grown rapidly. The online game industry, as people anticipated, is attracting more and more attention in the society and has caused wide concern in the business world. (Barbers & Doncel & Sainz, 2006, p199)

The term ‘online game’ refers to the virtual games in which players interact and compete over the Internet from their own computers. The online game industry is a complex web of activities. For instance, the structure of this industry has some dissimilarities as compared to other industries. Game producers are in charge of designing and exploiting a new game, and game operators buy management rights of a game from game producers, and then rely on telecom operators to reach their customers. Operators charge based on playing time or properties in the game. In addition, they can gain money through inserting advertisements into a game.

The emergence of the online game as a new kind of product on the Internet is different from the traditional game. Unlike traditional PC or console games, where one or two players play a game on a personal computer, online games allow many players around the world to play together on a game server via the Internet (Jiming Wu, De Liu, 2007). Thus, online games are different from other types of computer games because the players interact via the Internet and, simultaneously, play with one another. Players who paid the same time and same money can get different experiences due to the different ways they play. Online games, therefore, become a way to communicate with other people in cyberspace, as well as a medium for entertainment. Due to the necessity of computers and networking for the online game industry, any development in computers and the network industry will bring influence to bear on its development.

As an individual operator within this infant, and fast growing, industry, what kind of strategies are they implementing? What factors concern them the most when they
make strategies? Reviewing the strategy literature, we can see that there are many factors that should be considered when enterprises make strategies. Porter (1980) indicated that, when companies make strategy, they should be aimed at surpassing their competitors and paying attention to the external environment within the industry in which they operated, such as technology, substitutes, and their supplier, whereas other experts argued that enterprise should utilize their own abilities and resources to make strategy (Andrews, 1971; Ansoff, 1965; Hofer & Schendel, 1978).

The technology within the online game industry has been developing so fast, relying on network industry, online game industry have too much characters such as production, industry structure and operate process and these characters calls for a research for this industry. Fortunately, many traditional strategy theories have given us guidance about how to make strategies for companies. Based on these theories, we can make brilliant strategies for many traditional enterprises. However, can we apply these theories into a new industry? Will they still apply to an infant industry? Thus, in this study, the authors will test whether traditional theory is still suitable for the online game industry and, hopefully, make suggestions for improvement to these classical theories in order to make them more suitable for this new industry.

In this study, the authors take the Chinese online game industry as the focus because the rapid growth of online gaming businesses in China attracts more and more attention. Mirko Ernkvist and Patrik Strom (2008) pointed out that “China, a fast growing country with the highest absolute number of online game players in the world, provides an interesting context to study how real-world factors such as structure of this industry, technology, policy, culture influence the online game industry.” Although online games began to appear in China in the late 1990s, they did not make a real breakthrough until 2001. Since then, the Chinese online game industry has been growing rapidly. In 2007, the market size of China's online game is 12.8 billion Yuan, with a year-on-year increase of 66.7%, which is higher than the growth of the global online games. What factors make this industry in China have a fast development? What strategies are the operators using? And why have they chosen these strategies?

1.1 Research question:

What strategies are employed mostly by online game companies in China? And what are the most important factors (both internal and external) affect the decision making process?

1.2 Purpose

The authors would like to describe the present strategies that are used by major online game companies in China, and analyze the internal and external factors with the aid of interviews and empirical data. It is not strategy evaluation work that the authors
would like to do, but the summary and analysis of the present strategies of the on line game companies.

Because of the unique structure of the industry, the strategies might not be the same as the traditional industries, and the characters of being high technology dependent, short product life cycle, having many market segments, and so on, might also lead to other strategies that are different from those of traditional industries.
2. Theory frame

The purpose of the dissertation is to find out the strategies that are used by major online game companies in China and the internal and external factors that affect the decision making. The authors frame the theories based on the purpose of the study.

2.1 What is strategy

When we review the literature related to strategy, there are many different definitions. Mintzberg (1987) pointed out that strategy is a plan that has been made previously with a certain purpose. Quinn (1980) also indicated that a strategy is the pattern or plan that integrates an organization’s major goals, policies and action sequences into a cohesive whole. At the same time, Andrews (1987) believed that corporate strategy is the pattern of decisions in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals, and defines the range of business that the company is to pursue, the kind of economic and human organization it is or intends to be, and the nature of the economic and noneconomic contribution it intends to make to its shareholders, employees, customers, and communities. Another view takes strategy as a pattern—which is consistency in behavior, whether or not intended (Mintzberg, 1987). It implies that the manager or CEO implements certain kinds of strategy in their behavior, but even they do not know exactly what their strategy is. Although companies do not have a clear strategy for themselves, they are following certain directions or goals to some extent. They showed their strategy through their consistent behavior.

In our study, the authors try to combine two definitions—position and plan together to sum up companies’ strategy.

2.2 Strategy Formulation

2.2.1 External environment analysis

An important requirement in the process of strategy making is the appraisal of the external environment within which the company operates. Porter (1980) argued that “the essence of formulating competitive strategy is relating a company to its environment.” This is because the choice of strategies, and the means by which they are implemented, are determined by the character of this external environment in part (Morden, 2007, p.93).

It is, therefore, necessary for managers to understand the character and variety of the external situation which will influence strategy formulation and decision-making. The
organization needs to be aware of the extent to which it must be prepared to adapt to influences that derive from these external forces.

This assessment process which analyzes the external environment is sometimes named as a” PEST” analysis (Morden, 2007, p.94). Another strategy analysis tool, introduced by Michael Porter (1980), is the five forces analysis. In our study, we use PEST, together with industry life cycle, as microenvironment analysis tool and five forces as our microenvironment analysis tool, which is shown in Figure 2.1. This figure is partly from Morden’s book, which is titled “Principles of Strategic Management”; according to this study’s need, the authors added some supplement, as follows:

![Figure 2.1 External analysis model](image)

### 2.2.1.1 PEST analysis

The acronym PEST means “Political, Economic, Social, and Technological” factors within the external environment (Morden, 2007, p.94). It is used to describe a framework for the analysis of these macro-environmental factors. In the online game industry, these external factors more or less influence strategy formulation for online game operators. In PEST analysis, a scan of the external macro-environment in which the firm operates can be expressed in terms of the following factors:

1. **Political**

   This includes government regulations and legal issues, and defines both formal and informal rules under which the firm must operate. Policies can encourage the online game industry’s development and regulate it. Mirko Ernkvist and Patrik Strom (2008) suggested that the Chinese online game industry is deeply enmeshed in, and shaped by,
the political environment of the autocratic Chinese system.

Some political factors which may influence the online game industry include:
- tax policy
- employment laws
- environmental regulations
- trade restrictions and tariffs
- political stability

2. Economic

Economic factors affect the purchasing power of potential customers and the firm's cost of capital. In the online game industry, the economic growth makes a promising market to the operators. The following are factors in the macro-economy we should be concerned with most if the companies want to develop their international market:
- interest rates
- exchange rates
- inflation rate

3. Social

Social factors include the demographic and cultural aspects of the external macro-environment. These factors affect online game customers’ needs and the size of potential markets. Some social factors include:
- health consciousness
- population growth rate
- age distribution
- career attitudes
- emphasis on safety

4. Technological

Technological factors can lower barriers to entry, reduce minimum efficient production levels, and influence outsourcing decisions. Some technological factors include:
- R&D activity
- automation
- technology incentives
- rate of technological change

2.2.1.2 Porter’s Five Forces

“Strategic planners need to be fully aware of the structure of the trade or industry in which the enterprise operates” (Morden, 2007, p.95). Porter (1980) provided a framework that models an industry as being influenced by five forces. The strategic business manager seeking to develop an edge over rival firms can use this model to better understand the industry context in which the firm operates. These five factors
are follows:

I. Rivalry

Firms strive for a competitive advantage over their rivals. The intensity of rivalry among firms varies across industries, and strategic analysts are interested in these differences.

If rivalry among firms in an industry is low, the industry is considered to be disciplined. The intensity of rivalry is commonly referred to as being cutthroat, intense, moderate, or weak, based on the firms' aggressiveness in attempting to gain an advantage.

The intensity of rivalry is influenced by the following industry characteristics:

A larger number of firms increase rivalry because more firms must compete for the same customers and resources. The rivalry intensifies if the firms have similar market share, leading to a struggle for market leadership. Slow market growth causes firms to fight for market share. In a growing market, firms are able to improve revenues simply because of the expanding market.

Low switching costs increases rivalry. When a customer can freely switch from one product to another there is a greater struggle to capture customers. Low levels of product differentiation are associated with higher levels of rivalry. Brand identification, on the other hand, tends to constrain rivalry.

Strategic stakes are high when a firm is losing market position or has potential for great gains. This intensifies rivalry.

High exit barriers place a high cost on abandoning the product. The firm must compete. High exit barriers cause a firm to remain in an industry, even when the venture is not profitable. A common exit barrier is asset specificity. When the plant and equipment required for manufacturing a product is highly specialized, these assets cannot easily be sold to other buyers in another industry.

Boston Consultancy Group founder Bruce Henderson (1963) generalized this observation as the Rule of Three and Four: a stable market will not have more than three significant competitors, and the largest competitor will have no more than four times the market share of the smallest. If this rule is true, it implies that:

- If there are a larger number of competitors, a shakeout is inevitable
- Surviving rivals will have to grow faster than the market
- Eventual losers will have a negative cash flow if they attempt to grow
- All except the two largest rivals will be losers

II. Threat of Substitutes

In Porter's (1980) model, substitute products refer to products in other industries. A product's price elasticity is affected by substitute products - as more substitutes become available, the demand becomes more elastic since customers have more alternatives. A close substitute product constrains the ability of firms in an industry to
raise prices.

The competition engendered by a threat of substitute comes from products outside the industry. While the threat of substitutes typically impacts an industry through price competition, there can be other concerns in assessing the threat of substitutes.

III. Buyer Power

The power of buyers is the impact that customers have on a producing industry. In general, when buyer power is strong, the relationship to the producing industry is near to what an economist terms a ‘monopoly’ —— a market in which there are many suppliers and one buyer. Under such market conditions, the buyer sets the price. In reality, few pure monopolies exist, but frequently there is some asymmetry between a producing industry and buyers. Porter (1980) argued that the following tables outline some factors that determine buyer power.

Buyers are powerful if:
- Buyers are concentrated - there are a few buyers with significant market share.
- Buyers purchase a significant proportion of output - distribution of purchases or if the product is standardized.
- Buyers possess a credible backward integration threat - can threaten to buy producing firms or rivals.

Buyers are weak if:
- Producers threaten forward integration - producer can take over own distribution/retailing
- Significant buyer switching costs - products not standardized and buyer cannot easily switch to another product.
- Buyers are fragmented (many, different) - no buyer has any particular influence on product or price.
- Producers supply critical portions of buyers’ input - distribution of purchases.
- Referring to online game industry, the buyer is the player.

IV. Supplier Power

A producing industry requires raw materials - labor, components, and other supplies. This requirement leads to buyer-supplier relationships between the industry and the firms that provide it the raw materials used to create products. Suppliers, if powerful, can exert an influence on the producing industry, such as selling raw materials at a high price to capture some of the industry's profits. Porter (1980) gave following factors that determine supplier power.

Suppliers are powerful if:
- Credible forward integration threat by suppliers
- Suppliers concentrated
- Significant cost to switch suppliers

Suppliers are weak if:
- Many competitive suppliers - product is standardized
- Purchase commodity products
- Credible backward integration threat by purchasers
- Concentrated purchaser

According the five forces model, the online game strategy planner can have a better understanding of the micro-environment of the online game industry.

### 2.2.1.3 Industry life cycle

Oliver Williamson (1975, pp. 215–216) has depicted the industry life cycle as, “Three stages in an industry’s development are commonly recognized: an early exploratory stage, an intermediate development stage, and a mature stage.

The first or early formative stage involves the supply of a new product of relatively primitive design, manufactured on comparatively unspecialized machinery, and marketed through a variety of exploratory techniques. Volume is typically low. A high degree of uncertainty characterizes business experience at this stage.

The second stage is the intermediate development state in which manufacturing techniques are more refined and market definition is sharpened, output grows rapidly in response to newly recognized applications and unsatisfied market demands. A high but somewhat lesser degree of uncertainty characterizes market outcomes at this stage.

The third stage is that of a mature industry. Management, manufacturing, and marketing techniques all reach a relatively advanced degree of refinement. Markets may continue to grow, but do so at a more regular and predictable rate: established connections, with customers and suppliers (including capital market access) all operate to buffer changes and thereby to limit large shifts in market shares. Significant innovations tend to be fewer and are mainly of an improvement variety.”

Based on above theories, we can see that, at different stages, online game operator should have different strategies. In the early formative stage, they should focus on R and D development. In the second stage, they should pay attention to the market. In this study, the authors like to analyze which stage Chinese online game companies are in and find the factors that influence the strategy formulation.

### 2.2.1.4 Markets

The markets within which the enterprise operates are a key constituent of the external environment. Whether the enterprise is a business organization, a public sector body, or a not-for-profit institution, there will be a need for effective market analysis as a fundamental input to the process of strategy formulation and strategic decision-making. This is because the nature and behavior of markets determines or constrains the choice of strategies, and the means by which they are to be implemented (Morden, 2007)
The process of market analysis comprises (Morden, 2007):

- Market research
- The assessment of business risk
- Sales and market forecasting
- The analysis of consumer and buyer behavior
- Market segmentation

2.2.2 Internal factors

The purpose of this dissertation is to explore strategies of major online companies in China and analyzes the affecting factors (internal and external) of the strategy making process. The authors focus on the resources and capabilities of a company as the major internal factors.

According to the resource-based view, in order to develop a competitive advantage the firm must have resources and capabilities that are superior to those of its competitors (Andrews, 1971; Ansoff, 1965; Hofer & Schendel, 1978). Without this superiority, the competitors could simply replicate what the firm was doing and any advantage would quickly disappear. Resources are the firm-specific assets useful for creating a cost or differentiation advantage and that few competitors can acquire easily (Barney, 1991, p.106). Capabilities refer to the firm's ability to utilize its resources effectively (Barney, 1991, p.101-102). The capability of obtaining the resource and the distinctive competences of the company are the internal factors that the authors would like to explore.

Porter (1985) argued that, generally, there are two types of competitive advantage a company can possess: cost advantage and differentiation advantage. A competitive advantage exists when the firm is able to deliver the same benefits as competitors but at a lower cost (cost advantage), or deliver benefits that exceed those of competing products (differentiation advantage). (Grant, 1991, p.123) Thus, a competitive advantage enables the firm to create superior value for its customers and superior profits for itself.

The generic strategy is the model of analyzing internal factors affecting the strategy making process and will help the authors in summarizing the strategies of the online game industry.

2.2.2.1 Cost Leadership Strategy

This generic strategy calls for being the low cost producer in an industry for a given level of quality (Porter, 1985, p.11). As businesses rushed to invest in the “new” economy (E-business), thinking of making profit in the Internet boom, the payoff of such investments was not as important as making the move or taking action (Jing, 2008, p.82). The strategies on firm take will be very significant. The firm sells its
products either at average industry prices, to earn a profit higher than that of rivals, or below the average industry prices to gain market share. In the event of a price war, the firm can maintain some profitability while the competition suffers losses. Even without a price war, as the industry matures and prices decline, the firms that can produce more cheaply will remain profitable for a longer period of time. The cost leadership strategy usually targets a broad market.

Firms that succeed in cost leadership often have the following internal strengths: (Porter. 1985, p.13)

- Access to the capital required to make a significant investment in production assets. This investment represents a barrier to entry that many firms may not overcome.
- Skill in designing products for efficient manufacturing, for example, having a small component count to shorten the assembly process.
- High level of expertise in manufacturing process engineering.
- Efficient distribution channels.

2.2.2.2 Differentiation Strategy

A differentiation strategy calls for the development of a product or service that offers unique attributes that are valued by customers and that customers perceive to be better than, or different from, the products of the competition (Porter, 1985, p.14). The value added by the uniqueness of the product may allow the firm to charge a premium price for it. The firm hopes that the higher price will more than cover the extra costs incurred in offering the unique product (Porter, 1985, p.14). Because of the product's unique attributes, if suppliers increase their prices, the firm may be able to pass along the costs to its customers who cannot find substitute products easily.

Firms that succeed in a differentiation strategy often have the following internal strengths:

- Access to leading scientific research.
- Highly skilled and creative product development team.
- Strong sales team with the ability to successfully communicate the perceived strengths of the product.
- Corporate reputation for quality and innovation.

The authors would like to explore the internal factors that affect the strategy making process combined with those two generic strategies by using the models below.

2.2.2.3 SWOT analysis

SWOT analysis is a scan of the internal and external environment which is an important part of the strategic planning process (Have & Stevens & Pol-Coyne, 2003, p.185). Environmental factors internal to the firm can usually be classified as strengths (S) or weaknesses (W), and those external to the firm can be classified as
opportunities (O) or threats (T). Such an analysis of the strategic environment is referred to as a SWOT analysis.

The authors would employ SWOT analysis as the major tool for analyzing internal factors that affect the decision making process.

The SWOT analysis provides information that is helpful in matching the firm's resources and capabilities to the competitive environment in which it operates. As such, it is instrumental in strategy formulation and selection (Have, al. 2003, p.187). The following diagram shows how a SWOT analysis fits into an environmental scan:

Strengths

A firm's strengths are its resources and capabilities that can be used as a basis for developing a competitive advantage:

- Strong brand names
- Good reputation among customers
- Cost advantages from proprietary know-how
- Favorable access to distribution networks

Weaknesses

The absence of certain strengths may be viewed as a weakness:

- A weak brand name
- Poor reputation among customers
- High cost structure
- Lack of access to key distribution channels

Opportunities

The external environmental analysis may reveal certain new opportunities for profit and growth:

- An unfulfilled customer need
- Arrival of new technologies
- Loosening of regulations

Threats

Changes in the external environment may also present threats to the firm:

- Shifts in consumer tastes away from the firm's products
- Emergence of substitute products
- New regulations
- Increased trade barriers (Have, al. 2003, p186-189)
The SWOT Matrix

A firm should not necessarily pursue the more lucrative opportunities. Rather, it may have a better chance at developing a competitive advantage by identifying a fit between the firm's strengths and upcoming opportunities. In some cases, the firm can overcome a weakness in order to prepare itself to pursue a compelling opportunity (Chermack & Kasshanna, 2007, p.384-395).

To develop strategies that take into account the SWOT profile, a matrix of these factors can be constructed. The SWOT matrix (also known as a TOWS Matrix) is shown below:

<table>
<thead>
<tr>
<th>Opportunities</th>
<th></th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>S-O strategies</td>
<td>W-O strategies</td>
<td></td>
</tr>
<tr>
<td>S-T strategies</td>
<td>W-T strategies</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 2.3 SWOT Matrix**

S-O strategies pursue opportunities that are a good fit to the company's strengths.
W-O strategies overcome weaknesses to pursue opportunities.
S-T strategies identify ways that the firm can use its strengths to reduce its vulnerability to external threats.
W-T strategies establish a defensive plan to prevent the firm's weaknesses from making it highly susceptible to external threats.
3. Methodology

3.1 Research approach

3.1.1 Deductive versus inductive approach

There are two different approaches that the authors could employ: deductive approach and inductive approach, which represent different relationships between theory and data. With the deductive approach “the researcher, on the basis of what is known about a particular domain, deduces a hypothesis that must be subjected to empirical scrutiny,” (Bryman and Bell, 2007, p.11) while the process of induction involves drawing generalizable inferences out of observations. In other words, with an inductive approach, theory is the outcome of the research. (Bryman and Bell, 2007, p.14)

For this study particularly, the authors formulate the research question after reviewing the existing literature and engaging with what others have written. With the focus on strategic management in the online game industry, the authors explore with the previous studies in the relevant field and analyze the empirical findings with the literature findings, which is the deductive approach. The method of inductive approach requires observations and findings that the authors can generalize into theories, due to the lack of the knowledge, we think the inductive approach is hard for the authors to employ. The purpose of the research is to explore and conclude the strategies that are used by major online game companies and the internal and external factors that affect the decision making process based on the empirical study and theory framework. It is more like testing rather than generating theories (Bryman & Bell, 2007, p.29), hence we employed deductive approach as our research method.

3.1.2 Qualitative versus quantitative research approaches

A qualitative research approach emphasizes the generation of theories and the ways individuals interpret their social world, (Bryman and Bell, 2007, p.28) while a qualitative research approach is based on the testing of theories, and embodies a view of social reality as an “external, objective reality” (Bryman and Bell, 2007, p.28).

There are pros and cons for both approaches. The outcome of a quantitative approach usually comes from the analysis of a massive quantity of data that is assumed to be more reliable, while the results of qualitative research methods are assumed to be less convincing when the qualitative data are not generated or collected. (Bryman & Bell, 2007, p.402) However, with the qualitative approach, the researchers could get an insider view of strategic change by acquiring empirical data directly.
In this dissertation particularly, as we are considering an emerging and high-tech industry, there is little data for us to collect, especially when it comes to strategic formulation in the online gaming industry, and the authors would like to have an in-depth view with the research questions: what are strategies that employed mostly by online game companies in China? And what are the internal and external factors that affect strategic making process? In order to answer the questions, the authors are expected to have an inside view of the industry which requires qualitative data rather than quantitative data. On one hand, if the quantitative approach is employed, the result of the research might not be as deep as expected, but more realizable; On the other hand, when the qualitative approach is employed, the authors might get a desirable outcome, but would be facing the fact of it being less trustworthy. However, the result still can be reliable if data are generated in an appropriate way. As a result, the qualitative approach is chosen.

3.2 Investigation approach

Depending on the complexity of the purpose, different investigation approaches can be used. Either the intensive approach (where the subject is investigated in depth), or the extensive approach (where the subject is investigated more widely), could be used. The former allows the authors to examine a subject deeply, and is useful when one wants to gain better understanding of a specific situation or issue, whereas the latter requires the authors to examine and investigate more than one unit. The intensive approach would be used in the research of certain firms by conducting semi-structured interviews in order to get deep understanding of the strategies. The authors would like to have a deep understanding of strategies that these three sample online game companies are using as well as the internal and external factors that affect the strategy-making process. For the research of the whole industry, the authors would like to employ the extensive approach, with empirical data to get an overview of the industry.

3.2.1 Multiple case study

In the research, three online game firms will be taken as cases in order to get an in-depth analysis of the firms’ strategies. All these three companies are in the top ten online game companies in the Chinese market. They are SNDA, Net Ease and Nine City. Due to the distance between China and Sweden, the authors took online video conferences as the method of connecting the middle level managers in the three companies. The chosen samples represent different market segments as well as different operating strategies, which we assumed can represent almost all Chinese online game companies.
3.3 Data collection

With the qualitative research approach, the data collection of the dissertation is based on empirical findings and primary data with the approach of semi-structured interviews. The empirical findings are collected to get a whole view of the industry, as well as the basic data of the sampled companies, and the external factors of strategy making process. The primary data are used to gain an in-depth understanding of the companies, both their strategies and the internal factors that affect the decision making process.

3.3.1 Primary data

There are many methods that authors could use. The authors use semi-structured interview as the method of acquiring primary data. By employing the interview, the process is flexible. Also, the emphasis must be on how the interviewee frames and understands issues and events—“that is, what the interviewee views as important in explaining and understanding events, patterns, and forms of behaviours.” (Bryman & Bell, 2007, p.209)

3.3.2 Secondary data

The secondary data, which is already documented facts, will be found in relevant literature at the library at the Halmstad University and on the Internet. The main secondary source will comprise articles found on Internet on various databases, as well as articles from newspapers etc, at the library of Halmstad University, as well as the annual reports of the firms that we selected.

3.4 Reliability and Validity

Reliability refers to the consistency of a measure of a concept. As in the process of collecting and analyzing the theory and data, stability, internal reliability and inter-observer consistency are the three aspects to which the author should pay attention (Bryman and Bell, 2007, p.162).

Validity refers to the issues of whether or not an indicator (or set of indicators) that “is devised to gauge a concept really measures that concept” (Bryman & Bell, 2007, p.163).

There are both pros and cons with secondary sources. The pros include the fact that they are not as time consuming to collect as primary sources, the result of which is that the investigator has big opportunities to collect more data from a variety of sources. Another advantage with secondary sources is that the material is easy to compare. However, the most significant con is that it might not be valid and may not
be up-to-date or 100 per cent relevant for the subject chosen.

The empirical data that the authors collected are mainly from published theses and figures from official annual reports or authorised research reports of the research agency. There is also some information that can be found on the Internet. For this part, the authors are very careful and have assessed that information critically with the help of the biggest online game review website, “17173.com”, in order to achieve the requirements of reliability.

The primary data the authors collected are through the method of semi-structured interview. The first hand data are valuable in the aspect of original information. However, the risk will rise for authors if there are false data. To avoid this, it requires a well-formed interview guide, as well as good analysis of the data, in order to achieve reliability and validity. Also, the interview questions the authors designed focus on the present strategies of the company and the influencing factors, like laws and technology. They are not “sensitive questions” for the company, so the authors do not think there will be “false answers”.

3.5 Critical aspects of the sources

The chosen literature for this report is that which the authors find most relevant, according to the area which is investigated and the ones which are most interesting to link to the empirical findings. Nevertheless, the depth of the information from the literature might be criticised as being superficial and not going into sufficient depth. However, the literature found is the most relevant according to the authors as well as being easy to apply to the empirical findings. The authors use the biggest online game review website (17173.com) in which we have reviewed both the products’ and the companies’ performance to check the reliability and validity of the data. With such a critical eye, the authors have tried their best to ensure the validity of the data.

As for the primary data, this requires the authors to reason the answers and decode the information really thoroughly (Bryman &Bell, 2007, p.234). The interview questions are not so “sensitive” to the companies.
4. Empirical data

4.1 Conceptual definition

*Online game operators*—this refers to Internet companies who operate online games developed by themselves or authorized by other, online game developers and gain incomes by providing value-added services to users and placing IGAs, including selling game-play time, game-play tools and related services (iResearch, 2008).

*Classification of net games*—"Net games" (also called "online games") must rely on the Internet, allowing for many players to play the PC game at the same time so that the players can enjoy the entertainment and leisure through interaction with other players (iResearch, 2008).

4.2 The background of Chinese online game industry

*(The empirical data which reflect the background of online game industry is mainly from iResearch 2008.)*

Since 2003, the market size of the online game in the world has been increasing at a rate of over 30% each year. In 2007, the market size of the online games in the world reached US$ 8.6 billion, with a year-on-year increase of 32.2%, a 2.5 times’ increase over five years.

In the global market of 2007, the online games of the USA accounted for 31% of the market, the biggest share, and followed by South Korea, which accounted for 23%. China, ranking the third, accounted for 20%. In 2007, China's market size of online games reached 12.8 billion Yuan, with a year-on-year increase of 66.7%.
Table 4.1 Market Size of Chinese Online Game Industry from 2003 to 2008

(iResearch, 2008)

The income of Chinese online games was about 2000 million in 2003, and reached 19100 million in 2007. During the five years, the global online game industry increased by 258.3%, while the Chinese online game industry increased by 622.2%, which was higher than the growth of the global online games.

In 2007, there were 207 online games in formal operation in China's market, of which games developed in China accounted for 64.7%; games developed in Korea took up 30.9%, and games developed in US occupied 1.4%. Thus, China's online games industry witnessed an increasingly notable trend of localization, and this had become much more obvious by 2007. Among the 76 new games of 2007, China's local games took up 69.7%, 5% more than games in operation.

Chart 4.2 Proportion of development countries of China's online games in 2007

(iResearch, 2008)
With the popularization of the Internet, home has become the major surfing place for online game users. About 66.3% of online game users surf the Internet at home, whereas 20.8% of the users surf online at net bars.

According to the types and characteristics of the current mainstream net games, the net games can be divided into: MMOG, MOG platform game and Webgame.

MMOG took up the majority of market shares of China's online games in 2007, which is 84.4%, with a revenue exceeding 10 billion Yuan. At the same time, the revenue of MOG reduced from 26% in 2006 to 12.5%, and platform games declined by 7%.

### 2003-2008 Market pattern of China’s online games

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<td>Web game</td>
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<tr>
<td>Platform</td>
<td>1.3</td>
<td>2.8</td>
<td>2.5</td>
<td>2.8</td>
<td>3</td>
<td>3.5</td>
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<tr>
<td>MOG</td>
<td>1.1</td>
<td>2</td>
<td>6</td>
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<tr>
<td>MMOG</td>
<td>17.6</td>
<td>28.5</td>
<td>39.5</td>
<td>60.2</td>
<td>108</td>
<td>159</td>
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<tr>
<td>Grow rate</td>
<td>66.5%</td>
<td>44.1%</td>
<td>60.0%</td>
<td>64.1%</td>
<td>51.6%</td>
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Unit: 100 million yuan

Table 4.3 2003-2008 Market pattern of China’s online games (17173.com, 2009)

### 4.3 Main customers

When compared with the overall attributes of users participating in the large-scale survey, online game users are especially characterized by their young ages. Internet users aged below 18 account for 19.1%, while online game users represent 33.4%; Internet users aged below 24 account for 50.9% of the total, while online game users comprise 64%. With respect to educational background, 49.5% of the online game users have not entered higher education, while the figure among Internet users than online game users is 33.8%. So, Internet users tend to have better education than online game users. With respect to gender distribution, male players are much more prevalent than female ones, and those aged between 18 and 35 in particular. (17173.com, 2009)

### 4.4 Market size of Top 15 Chinese online game operators of 2007

Of the top 15 Chinese online game operators in terms of revenue in 2007, 10 were listed companies, with a revenue of 9.87 billion yuan, accounting for 77.1% of total revenue. 9 you and Sealonline were two of the top ten unlisted companies, and they
planned to become listed in the Stock Exchange in 2008, and take up over 90% of market shares by 2009.

In 2007, SNDA ranked first among Chinese online game operators, with a revenue of 2.4 billion Yuan, its turnover takes up 18.8% of market size of online games. NetEase ranked the second place, with revenue of 1.87 billion Yuan. ZT game was the third slot, with revenue of 1.55 billion Yuan. These three companies earn the most revenues from their independently developed products. The 9, which serves as an agent, ranks fourth. After them, 9 you, Tencent, Netdragon, Perfect World, Sealonline and Kingsoft rank from fifth to the tenth. (17173.com, 2009)

Chart 4.4 Market shares of revenues of Chinese online game operators of 2007

(iResearch, 2008)

4.5 Profit of telecom companies

As a major and indispensable supplier of the online game industry, the profits that online game companies bring to them is considerable.

The telecom companies enjoyed a 20% growth of income because of the increase of business brought by the online game industry. The online game industry has brought telecom companies 31.28 billion of income, which is 1.7 times of the sales income of the whole online game industry, and the telecom companies have taken approximately 50% of the profit of the online game industry.
4.6 Case study

4.6.1. SNDA

SNDA Interactive Entertainment Limited (NASDAQ GS: SNDA) is a leading interactive entertainment media company in China. SNDA offers a portfolio of diversified entertainment content, including some of the most popular massively multi-player online role-playing games (MMORPGs) and advanced casual online games in China, as well as online chess and board games, e-sports game platform and a variety of cartoons, literature works and music. SNDA’s interactive entertainment platform attracts a large and loyal user base, of which more and more is coming from homes. Each user can interact with thousands of other users and enjoy the interactive entertainment content that SNDA provides. Interaction enriches your life. (SNDA Webpage, 2009)

SNDA began to operate in online games in 2001 and has launched at NASDAQ in May 2004. Beginning in 2004, SNDA has transformed from an operator which has only has two online games "Legend" and "Legends of the World", into the biggest operator in China, and which has diversified games (MMOPRG games, casual games, war games board games, etc) and a diversification of business models (games, wireless value-added services, game peripheral products, advertising and consumer electronics products, etc.).

SNDA has cooperated with some famous online game companies, both foreign and domestic, to enhance their market share in the Chinese market as well as entering into international markets.

In November 2004, SNDA brought the Korean company Actoz.

In December 2005, SNDA bought the casual game platform “Tea House”.

In May 2005, SNDA started to operate with Disney Net and introduced Disney entertainment into Chinese market.

In 2007, SNDA launched three major investment schemes to attract good game producers. SNDA spent two billion yuan to buy successful online games as well as online game companies.

In July 2007, Cheng Du Jingtian was purchased by SNDA in order to enlarge the market share in China.

In November 2007, SNDA made an alliance with famous Korean online game company Nesoft. (SNDA development, 2009)

Through the series of strategies, SNDA has achieved their two goals:

1. Enlarging their product line and enhancing their competitive advantage.
2. Raising the entry barriers and reducing the threat of new entrants.

Products & Operation of SNDA

Chart 4.5 Incomes on SNDA from 2005 to 2007 (Quarter 1 to Quarter 4)

The chart shows that the most profitable business of SNDA is MMORPG games, and the casual games are struggling. In fact, Mr. Li (Marketing manager of SNDA) says that “Although it seems the income of MMORPG games are great, the net income of this part is not increasing proportionately because of the rising costs.”
4.6.2 NetEase

NetEase.com, Inc. is a leading, China-based, Internet technology company that pioneered the development of applications, services and other technologies for the Internet in China. NetEase's online communities and personalized premium services have established a large and stable user base for the NetEase websites which are operated by its affiliates. In particular, NetEase provides online game services to Internet users through the licensing, or in-house development, of massively multi-player online role-playing games, including Fantasy Westward Journey, Westward Journey Online II, Westward Journey Online III and Datang. (NetEase webpage, 2009)

NetEase is not only an online game operator, but also operates as the biggest website in China. This means they already have experiences in operating, and their main profit comes from online games. NetEase operates mainly on the development and operation of MMORPG games. Since 2004, when the number of players online reached one million, NetEase has enjoyed a great level of interest.

NetEase has developed their own online games “Westward Journey 2” and “Fantasy Westward Journey” as their representative work in the industry. Thanks to the independent research and development, the game is very profitable. (NetEase webpage, 2009)

**Products & Operation of NetEase**

```
NetEase
  └── Online games
      └── MMORPG
          ├── PaoPao casual game platform
          └── Brand web advertise
              ├── Other advertise
              └── Web advertise
                  └── News and information services
                      ├── Community services
                      └── Download services
                  └── Wireless services
                      └── Websites
                          └── Others
```

Chart 4.6 Income of NetEase from 2005 to 2007 (Quarter 1 to Quarter 4)

The chart shows clearly that the increasing of the income does not mean the increasing rate is rising as well. In fact, the increasing rate is quite fluctuating. Mrs. Tang (The first assistant of marketing director of NetEase) explains the phenomenon as “the costs of maintaining hardware and updating software will go up along with the increasing number of players.”

4.6.3 Nine City

Nine City (The 9) is a leading online game operator in China. The 9’s business is primarily focused on operating and developing high-quality games for the Chinese online game market. The9 directly, or through affiliates, operates licensed MMORPGs, consisting of MU, Blizzard Entertainment's World of Warcraft, Soul of The Ultimate Nation, Granado Espada, and its first proprietary MMORPG, Joyful Journey West, in mainland China. It has also obtained exclusive licenses to operate additional MMORPGs and advanced casual games in mainland China, including Hell Gate: London, Ragnarok Online 2, Emil Chronicle Online, Huxley, FIFA Online 2, Audition 2, Field of Honor, Audition and Atlantica. In addition, The9 is also developing various proprietary games, including Warriors of Fate Online.

Ninth City was established in August 1999, focusing on the operation of its online games business and has launched at NASDAQ in 2004. In 2002, Nine City started its operations of Korean classic online games "Miracle", developed by Ninetowns Webzen. In April 2004, Nine City has officially announced its cooperation with Blizzard Entertainment, introducing the world's top online game "World of Warcraft" (World of Warcraft) to China. (The 9 web page, 2009)

In 2007, Nine City started operating in casual game and changing the charging mode. In order to reduce the risk of operating few major games, Nine City has cooperated with Korean companies to explore the casual game market. (IDC research, 2007)
In April 2008, Ninth City announced that it was to become a shareholder of the Korean online game company, G10.

In April 2008, Ninth City started to cooperate with Korean top game producers N Dores.

Chart 4.7 Income of Nine City from 2005 to 2007 (Quarter 1 to Quarter 4)

In the chart, the same problem has been revealed, that is, the increasing of income does not bring the increasing of increasing rate. Mr. Zhao (Nine City’s marketing manager of southeast China) says that “the authorizing fee of the major game ‘World of Warcraft’ takes up lots of the profit.”
5. Analysis

5.1 Industry Life Cycle of Chinese Online game industry of online games

Online games started to appear on the market in China in 2000. Based on Oliver Williamson (1975), we think the development of the Chinese online game industry can be divided into two stages, including the formative period and the intermediate period.

1. Formative period

The introduction period lasted a short time, 4-5 years. During this period, many excellent foreign games were introduced to China. Since there were only a few games being introduced, the users consisted mainly of those people who start to use Internet earlier. Chinese online game operators mainly relied on introducing foreign online games. The main feature in this stage is mentioned by Oliver Williamson (1975, pp. 215–216), the volume of online games was typically low, but the technology related to the online game industry changed fast. To cope with their competitors, the online game operators paid a lot of attention to how to improve their research and development ability and tried to explore their own products—the technology was the main factor that influenced strategy formulation in the online game industry.

2. Intermediate period

During the period of 2005 to 2008, with the popularization of cyber cafe and LAN, online games got an explosive development in China. During this period, games were mainly introduced from South Korea. Since the games of South Korea were easy in operation and had lower requirements for the PC, these games became the leading products in the Chinese market.

From 2005 to 2008, Chinese games, and games of the USA and Europe, had been springing up. Many competitors entered into the market——the increasing numbers of online game operators gave rise to fierce competition.

In 2007, SANDA ranked the first among Chinese online game operators, which was followed by Netease and ZTgame. These three companies earned the most revenues from their independently developed products (iResearch, 2008). The 9, which served as an agent, ranked fourth. Boston Consultancy Group founder, Bruce Henderson (1963) generalized this observation as the Rule of Three and Four; that a stable market will not have more than three significant competitors, and the largest competitor will have no more than four times the market share of the smallest. Based on this opinion, and the data we collected, the competition in the market was intensified and the market share is gradually concentrated in several big companies. However, there were still more than three companies holding this market share, so we think the Chinese online game industry was not that stable as a mature industry; it was in the growth period.
In this stage, there were many technologies involved in this industry, and some of them were fast changing. To meet the growing need, operators had to improve their technology——thus many operators chose to collaborate with other companies in order to exchange their technology and enlarge their market.

Williamson (1975) pointed out that a high, but somewhat lesser degree of uncertainty characterized market outcomes at this stage. According to the features in this period, the authors think that the online game industry had come into the late, intermediate stage. In this period, more and more operators had the ability to explore their own products and enlarge their product line. MMOG began to integrate with MOG in 2007, with a vague limit between them. It was only a matter of time for the merging of MOG into MMOG. In addition, as a new type game, Web game drew in more and more customers. To meet this increasing number of customers, many operators invested a lot in this field.

Hence we can safely draw the conclusion that, in this stage, when the online game operators made strategy, the most important factors were market and technology.

5.2 PEST Analysis

**Policy:** In 2003, online games was listed in national "863" science and technology program by the Ministry of Science and Technology in China (People’s Daily, 2003). In 2004, CAPP and the State Copyright set a requirement for the online game operator——operators in China should obtain approval from GAPP and State Copyright Bureau for operation (People’s Daily, 2004). These policies encourage Chinese online game operators to explore their own products and protect local operators’ development. China's online games have witnessed an increasingly notable trend of localization, and this has become much more obvious since 2007. Among 76 new games in 2007, China's local games took up 69.7%, 5% more than games in operation (iResearch, 2007).

**Economy:** The Chinese online game industry has had a great increase during the period of 2003 to 2008. In this period, China had enjoyed increased economic stability which created a favorable and steady environment for the development of the online game industry. With the popularization of Internet, and the fast growth of the penetration rate of online games in the country, China has become the region with the most intensive users of online games.

**Social:** Compared with 2006, the fast growth of market size in 2007 was mainly due to the fact that game operators focused on developing potential customers. Due to the different backgrounds and habits of customers, operators have enlarged their product lines and paid attention to new types of online games in order to attain potential customers. Experienced operators run different kinds of online games to meet different needs.

**Technology:** When online games are played by customers, the quality of customer service, in particular, will directly affect game experience of users (iResearch, 2008). The quality of games themselves only includes two aspects, namely unbalanced game setting and higher configuration of computers. To meet customers’ needs and build
operators’ core competitive advantage, online game operators pay more and more attention to their technology, both inside games, such as the quality and music, and outside games with things like service and upgrading. In addition, factors really affecting game life-cycle are game hook crack, cheating software and game safety, occurrence of which will directly result in failure of operators. To solve this problem, operators utilize policy and team up to improve their technology in this aspect.

Based on these analyses, it is clear that policy and technology have an important influence on this industry and thus influence strategy formulation.

5.3 Five Forces analysis

The bargaining power from online game producers is not very high, so experienced operators choose to explore their own games to reduce costs and build their own ability. However, in this industry, the operators rely on telecom companies much more than the game producers. Telecom companies provide service platforms for operators as well as game players and, thus, they have a quite high barging power and, as a result of that, they monopolized the Internet industry in China.

The game players are not concentrated very much and they do not have a backward integration threat. However, there are only a handful of amazing online games in China. Most games do not have strong attraction for players. So, to majority operators, the barging power from the buyer is still high. On the basis of the increase of both the numbers of users and the level of consumption, many operators supply more online games to meet this increasing need and improve the quality of the game in order to reduce the barging power from their buyer; the best way is to enlarge their product line.

As a production for entertainment, the online game has become the new primary leisure activity among teenagers and young adults. Other leisure activities have different characteristics compared to online games thus they have few possibility to influencing the online game industry. Traditional game enterprises are mainly relying on developing TV games and PC games, which still have a certain number of customers, but do not pose a threat to the online game industry. Any new game relying on the Internet will be developed by the online game industry. Hence, operators can ignore this factor.

The market size of the Chinese online games industry keeps expanding and it is sharing a larger and larger percentage in the global online games market. Although there are some small companies holding a certain market share, due to the limitation of finance and R&D ability, they will not present powerful threats to these big companies. Referring to those big companies, they will have to grow faster than the market (Hendersonh, 1963). Thus, more and more Chinese operators have begun to explore their own games rather than introduce only foreign online games. In order to achieve more market share, they have also chosen to collaborate with other companies.
5.4 Case analysis

With regard to case analysis, all three cases will follow the same form of analysis. The authors will firstly use SWOT analysis individually on the three chosen companies to provide an in-depth understanding of the environment of the industry, internally and externally. Then, the strategies of major online game companies will be summarized and analyzed. The empirical findings from all these three companies show that high income always along with low increasing rate, which draws us attention to have a cost analysis to find out reasons for the phenomenon, and how do these affect the strategy making process.

5.4.1 SWOT analysis

SWOT analysis is used to analyze the factors that are of great importance to the companies. The authors would like to analyze the internal factors that affect the strategy making process. In this part of the analysis, the authors try to find the answer to the research question “what are the internal factors that affect strategy formulating process?”, and explore the internal factors that affect strategy-making processes. After the SWOT analysis, the internal factors of the company’s performance will be concluded.

5.4.1.1 SNDA

Strength and Opportunity

1. Diversified product line and experienced operating. Thompson and Strickland (1980) argue that, for a strategy of being a product innovator, a relevant resource might be research and development skills. SNDA is the most experienced online game company with the diversified product line. It has invested in both mature game companies as well as new game producing companies to enlarge their competitive advantage as a leader in the Chinese market.

2. SNDA is very innovative and creative about the operation model. They have different charging methods for different market segments. They bought stocks of other online game companies in order to share the costs as well as benefits from the latest technology. In order to make use of every game, they make continuations of famous games to attract players. They have built a common platform for 20 of their games by using the same payment and bonus system, and the bonus can be used in any of the 20 games.

3. Online game community culture: the 20 games that are operated on the platform of SNDA use one and the same ID system. They have a professional team responsible for the service and maintenance. All these will reduce the risk of a short game life cycle. The culture of the games gives the players a better choice
of games, and the charging system gives players opportunity to play among many games. This is because players can use their money in the system to play any of the 20 games in the platform instead of just one game.

4. Brand power: SNDA is one of the most successful online game firms in China and has strong financial support. With the popularity of online games in China, SNDA brought the most successful games like "Legend" and "Legends of the World" into the Chinese market; with the help of these two games, SNDA built a leading brand in the online game industry. Since then, the brand value of SNDA is their competitive advantage.

5. Exploring the foreign market: SNDA cooperated with foreign companies as their strategy to extend their market. They have bought 30% of the stocks of NC Soft (a Korean company) to acquire higher market share.

Weakness & Threat

1. Their most successful online game, “Legend”, has taken too much of the company’s resources, and has resulted in unbalanced diversification of the company. Their other products, like casual games, have encountered challenges from Tencent, and this will slow the development of SNDA.

2. Fierce competition of the online game industry. Lots of newcomers want to share the market and make profits in this promising industry.

Internal factors

Operating capability: SNDA is the most experienced online game company with the diversified product line in order to achieve more market segments. SNDA has bought 30% of the stocks of NC Soft (a Korean company) to have a larger market share. They have employed the strategy of cooperation in order to have a long term development.

Distribution of product line: From MMORPG to casual games, SNDA operates on lots of kinds of games on the markets. The diversity of products enhances the market share of the company. It is also one of the internal factors that lead to the strategy of diversification.

Brand influence: SNDA is one of the most successful online game firm in China and the brand value of SNDA is their competitive advantage.

5.4.1.2 Net Ease

Strength & Opportunity

1. R&D ability is the core competitive advantage of Net Ease. It can lower the cost and raise the profit of the whole operating process. R&D capability is certainly the resource that sustains the company to secure future profits (Barney, 1986, p.1240).
2. As a Big Website, Net East has loyal customers and the operation channel. The experience of running the website can be used in the operation of online games. Thus, Net East has a natural advantage in management and operation.

**Weakness & Threat**

1. Net East relies too much on the game series “Westward Journey”. It is no doubt that the games have brought lots of profits to the company. However, because of the short product life cycle, it will affect the earning ability of Net East in the future.

2. Low diversification level: Net East has entered the casual game industry too late. The other self-developed games are less profitable.

3. Intensive competition.

**Internal factors**

R and D capability: R and D capability is the most significant competitive advantage of the company. With the ability of research and development, the company can enjoy the future growth. The R&D capability implies that they have the ability of self-development to employ the strategy of diversification in order to avoid the threat of low diversification level.

Operating capability: as one of the biggest websites in China, they are experienced in the field of online operating. With such experience, the companies can easily adapt to the strategy of diversification.

Brand influence: the brand influence of the online game company comes from their mother company – NetEase.com.

5.4.1.3 Nine City

**Strength and Opportunity**

1. Experienced operation: Porter (1980) argues that, for most strategies, management skill will be a resource required for successful implementation. Nine City only operates in the games that are elites and successful. Nine City has invested large capital in introducing successful foreign games into China, and it has moved to the development of games. Nine City has noticed the importance of diversification in the industry and has cooperated with a Korean company into the causal games market.

2. Competitive products: Nine City has authorized exclusive operation of the game "World of Warcraft" from 2005, and has signed contracts with the successful games “Hell Gate: London” and “Miracle World”.

3. Strong advertising and promotion ability: Nine City has promoted lots of successful games into the Chinese market. They cooperated with Coca-Cola to
promote the game “World of Warcraft”, and cooperated with Pepsi to promote the game “Fierce War”. With the development of online games, Nine City also developed their ability of cooperating with other industries.

4. R&D ability: Nine City has been involved in in self-development since 2007 to achieve higher profits.

Weakness & Threat

1. Fierce competition in MMORPG games: there are lots of companies operating in MMORPG games, such as: SNDA, Net East, Giant and Perfect Time. Although Nine City operates in the world’s most popular game “World of Warcraft”, they cannot prevent the fierce competition.

2. Lack of self-developed products: the expensive agency costs and the commercial disputes have increased the risks of operating games. Although Nine City is trying to self-develop, the process is long and hard. The lack of characters and high costs of operating lead to the decrease of profit of Nine City.

3. Lack of diversification: The major products are all MMORPG games. The game “World of Warcraft” accounts for 95% of the whole profit of the company. Because of the short product life cycle, this might be the major problem for Nine City’s future development.

Internal factors

Finance: the Nine City pays a lot in authorization fees to the game producers every year. They employ the strategy of cooperation with strong financial support.

Brand influence: the brand influence, in this case, does not come from the online game company but the game producer—Blizzard Entertainment. This is also one factor leading to the strategy of cooperation.

Operational capability: they have strong advertising and promotion ability in operation and cooperate with not only game companies, but also the companies with famous brands like Coca-Cola, to have good promotions.

5.5 Strategy analysis

Grant (1991) argues that designing strategy around the most critically important resources and capabilities may imply that the firm limits its strategic scope to those activities. These three online companies formed their strategies based on this argument. Porter (1985) has stated the competitive advantage is due to the cost advantage and the differentiation advantage. However, in specific industries, especially those which require the latest technology, it seems the generic strategy will be challenged.
5.5.1 SNDA

1. Diversification strategy: operating in different market segments.
2. Cooperating or acquisition.

SNDA has realized the importance of diversification in the industry and has put efforts into broadening its product line by introducing the causal game into its operation. By cooperating with other online game companies, it acquired more market share and raised the entry barriers for the newcomers.

5.5.2 Net Ease

1. Acquisition.
2. Diversification

As an online game company with great R&D ability, and possessing a great advertising platform (Net Ease is also a famous website operates in China), enlarging market share is the major task for the company.

5.5.3 Nine City

1. Diversification strategy: operating in different market segments.
2. Cooperating or acquisition.

Nine City, like SNDA, has also spotted the importance of diversification in the industry; instead of self-production, they chose to cooperate with other online game companies in order to share the cost of production and to learn from the successful companies.

Basically, all of the three companies’ strategies are the same. They all have sensed the needs of the market and acted on it at different levels.

5.6 Cost analysis

Through the performance of all the three online game companies we can spot that, although the incomes of all these three companies are rising in the overall view, the profit rate is not especially promising. The high maintainance cost is the major reason for this phenomenon. For all of these companies, the cost of telecom company services takes up 50% of their profits, and the costs will increase when the number of players is increasing. Normally, in this industry, the more players a company has, the better services are required, such as more server computers, more technical support, powerful hardware and marketing costs. Barney (1986) argues that firms can only obtain greater than normal returns from implementing their product market strategies when the cost of resources for implementing those strategies is significantly less than
their economic value. That means when they implement a certain strategy, the
managers should really weigh against the cost of the strategy the profit that they can
make.

5.6.1 Nine City

The authorization costs of the game producer are very high in Nine City. Along with
the development of the games, the fee paid to telecom companies is increasing as well.
Even if Nine City wants to self-develop, there is no guarantee that their self-produced
game would be successful. Besides, the R and D cost will be high if they want to use
the latest technique (this might be the way of avoiding failure of the games). What is
more, the cost of the market research and market promotion will be limitless.

5.6.2 SNDA

SNDA, the best online game company in China, is exploring the casual game market
presently. However, it is too late for SNDA to explore because Tencent had already
taken a huge market share in the field and has a well-performing game platform.
Besides, the brand loyalty of Tencent cannot be overlooked. As a result, it is hard for
SNDA to explore casual game market. The performance of SNDA causal game has
shown a low rate of increase, and it might affect the whole performance of the whole
company due to the high cost of developing the casual game market. SNDA might be
the most successful company in the Chinese online game industry, but the previous
success came from importing successful online games from abroad. On one hand, the
cost of authorization is substantial, and has an agreed time of operation. It might be
hard to get the following authorization because of the fierce competition. On the other
hand, the lack of R&D ability makes the self-produced games less competitive and,
normally, this means money is wasted. Compared with Net East, that is famous for the
self-produced games, the profit rate is relatively low in SNDA. SNDA has realized
that their competitive advantage will be enhanced with a wider product line and they
have put effort into that, but the limitation of R and D ability will be an impediment.

5.6.3 Net Ease

Net Ease is one of the few online game companies that possess good R&D ability.
The self-produced games bring them the high profit rates and a famous brand.
However, the diversification level of their product is low, and they have few games in
operation. It is unavoidable that the short product life cycle in this industry will affect
the company’s performance in the long run. Self-production will effectively reduce
the cost of authorization, but the cost of development of one game is high, and it is
hard to have an overall market research, which will result in failure of the game.
5.6.4 Summary

The cost situation of the three companies shows that the profit rate does not increase with the surge of income because of the raised cost during the operation, and the indispensable reliance on the telecom company, which takes up to 50% of the profit. Also, the change of strategy itself costs a lot.

This implies that, in the industry and this stage of development, it is hard to achieve a cost leadership strategy.
6. Conclusion

6.1 Strategies of major online game companies

*Diversification strategy*

All of the online game companies have realized that it is important to have more market segments. From MMORPG games to casual games, online game companies try to reach all the areas of the industry in order to maintain their competitive advantage.

*Cooperation or Acquisition strategy*

It is costly in this industry to maintain a competitive advantage. The strategy of cooperation of acquisition is a good way of enlarging market share as well as cost saving. Besides, the fast growing technology is another reason that online game companies would like to take this strategy.

The figure below shows the strategies employed by major online game companies and the factors (internal and external) which affect the decision making, which is the purpose of the dissertation.

<table>
<thead>
<tr>
<th>strategies</th>
<th>Internal factors</th>
<th>External factors</th>
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</thead>
<tbody>
<tr>
<td><strong>Diversification strategy</strong></td>
<td>Distribution of product line</td>
<td>Market need</td>
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<tr>
<td></td>
<td>Brand influence</td>
<td>Rivalry of the companies</td>
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<td></td>
<td>R&amp;D capability</td>
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<td></td>
<td>Operating capability</td>
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<tr>
<td><strong>Cooperation or Acquisition strategy</strong></td>
<td>Finance</td>
<td>Market need</td>
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<td></td>
<td>Operation capability</td>
<td>Technology need</td>
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<td></td>
<td>R&amp;D capability</td>
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Figure 6.1 Strategies employed by major online game companies and the factors

6.2 Hard to achieve cost leadership

The authors concluded that, in this industry, it is hard to achieve cost leadership strategy, which is one of the Porter’s (1985) generic strategies in this stage of development, for following reasons:

In the online game industry, the structure of the industry determines that the suppliers’ bargaining power is strong, especially the power of telecom companies, which hold approximately 50% of the profit of the industry.
The increase in the profits is accompanied by the rising costs of hardware, technical support as well as marketing spends. In order to have more market share, there are two ways for these online game companies to choose——explore more market segments or cooperate with other companies, which are usually costly.

The short life cycle of the game requires the company to design the new games to avoid sudden collapse of the company.

In this stage of development of the online game industry, reaching either the strategy of diversification, which can be assumed as the differentiation strategy, or the strategy of cooperation, is costly. There is a dilemma if one company wants to gain more profit.

In the industry, the wider product line the company possesses, the higher costs the company will bear. The self-produced games are not 100% sure to bring the profit for complex reasons.
7. Implications

7.1 Theoretical implications

The online game industry requires the latest technology and possesses a unique industry structure. The classical strategies might not fit in some new industry anymore because of the complex influencing factors, both internal and external. Porter (1985) says that “there are only three internally consistent and successful strategies for outperforming others” (Have, at al. 2003, p.86). These three strategies (cost leadership, differentiation and focus) are Porter’s generic strategy. In this case particularly, the authors conclude that it is hard for the online game industry to achieve cost leadership strategy, which is one of Porter’s (1985) generic strategies, in this stage of development. This is because of the high cost spending on suppliers (especially telecom companies), maintaining costs and strategy implementation costs. The other two strategies, differentiation strategy and focus strategy, still work well in the online game industry, as we have analyzed. However, they might lose their magic when facing certain new industries. Thus, the classical theory might need to be improved in order to guide the strategy formulation process in the new industries.

As the technology develops, the classical theories which developed 20 or 30 years ago will face challenges when encountering a new industry that possesses brand new characteristics. When we assess this cost leadership strategy, which is one of the classical Porter’s generic strategies, and combine it with the analysis of the online game industry, we can spot that the cost leadership strategy might not fit the companies that struggle in the industry to gain profit.

Therefore, the classical theories might need to be improved by having to take more variables into consideration. Take the online game industry for example. The power of technology, suppliers’ (especially telecom company’s) bargaining power, companies’ R&D capability and operation capability, are of great importance in the analysis process. This is especially the case when the industry itself has a very unique structure, namely that it relies on the telecom company too much and cannot change the fact at all.

7.2 Managerial implications

As the technology develops, the managers in the new industry with unique structure might be facing the problem of defining their strategies in an old way. This is because of the complex new influences, like latest technology and the changing of the selling methods; the strategies might change as well. So, it is important for the operators of the companies to acquire new knowledge of management and have an insight into the
new changes needed to adapt to the ever dynamic business environment.
8. Limitation and future research

Due to the limited time, the size of an online game company, which would be an important factor in strategy making process, is not in consideration in the research. The authors only research the major online game companies to conclude the major strategy of the online game industry in the Chinese market.

The environment of the online game industry is complex; many factors will influence strategy formulation which is not included in our theories. The factors excluded in this theory will not be evident.

Some factors interact with other factors. For example, the economic growth creates a promising environment to develop technology; it hard to distinguish the exact factor that influences strategy formulation.

The authors explored the strategies of the online game industry with an observation of the whole industry and the in-depth study of certain online game industries to establish the strategies that are used by major online game companies. However, the authors do not assess whether these strategies are proper for the company itself.

The research is about a certain area and towards a certain culture, so the social and political factors may be of great importance when extending the study to other cultures or countries. Thus, this might be a direction of future study.

Due to the endless development of the technology and the evolution of industry structure, the classical theories that focus on, and giving guidance to, traditional industries might not fit in the analysis of the new industries any longer. For a future study, it might possible to develop new theories for those new industries that are dependent on technology.
Interview guide

The three interviews we are conducting involve members of the middle-management team of the company. Because of the distance between China and Sweden, the authors have used online video conferencing to interview these managers. The authors would like to know, through the interviews, of the present strategies of the companies as well as the competitive advantages at the firm level. That means, during these semi-structured interviews, the authors would like to know the position of the companies and the internal and external factors in managers’ point of view that affect their strategies by asking, mainly, these following questions:

1. What are your development strategies for the last few years?
2. What is your the future development plan?
3. What do you think are the success factors of your company? And what can be considered as your competitive advantage?
4. What is your target market? Do you find any other potential market? There are so many online games in the Chinese market, how do you perceive the competition?
5. Which kind of game you like operate in the next year?
6. The Chinese government has launched a law to reduce youth (under 18 years’ old) playing time in 2004. Do you think this kind of laws will affect your company’s perform?
7. The government has also set some policy to encourage more Chinese online games. There is the trend for producing games within the company instead of buying from producers. And how about your plan?
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