

Competing for Dominance in the Game Industry

--A Strategic Analysis of Microsoft's Acquisition of Activision Blizzard

Huanyi Zhou^{1,a,*}, Laiying Qiu^{2,b}

¹Shenyang University of Chemical Technology, Shenyang, 110142, China

²Shenzhen Merchiston International School, Shenzhen, 518110, China

a. mercyzhou21@gmail.com, b. qiu2203@gmail.com

*corresponding author

Abstract: After enduring the impacts of a three-year pandemic, the gaming industry has witnessed a series of remarkable marketing activities. Amidst the continuous unveiling of novel products, the landscape has been disrupted by significant acquisitions among major gaming corporations, breaking the long-standing veneer of silence in the market. Among them a representative case is focuses on Microsoft's acquisition of Activision Blizzard. By combining an internal and external environment in which Microsoft made its acquisition decision, we analyse meticulously to the rationality and impetus behind the formulation of this strategic initiative. We further analyse the performance impact of this merger and acquisition strategy to further evaluate the effectiveness of the merger and acquisition strategy. Ultimately, based on our analysis, we propose corresponding suggestions sand insights for companies in the process of preparing for acquisitions and those within the gaming sector, with the objective of mitigating potential risks.

Keywords: Acquisition analysis, DuPont System of Analysis, Microsoft, Activation Blizzard, PEST Analysis

1. Introduction

The current outlook for the gaming industry can be described as highly promising. During the pandemic, the consumer market for gaming has been continuously expanding. Simultaneously, key technological factors such as cloud computing, artificial intelligence, and virtual reality have made significant breakthroughs, providing essential technological support for the development of the gaming industry. Moreover, advancements in technological aspects of business operations, including management systems, service upgrades, cost reduction, and enhanced competitiveness, have intensified competition within the gaming industry. This has led to various companies engaging in mergers and acquisitions (M&A).

Mergers and acquisitions encompass both mergers and acquisitions with different forms, such as horizontal, vertical, and mixed M&A strategies. In the gaming industry, horizontal M&A plays a predominant role, which refer to the merger and acquisition behavior between enterprises in the same industry. The advantage of horizontal merger and acquisition is that it can rapidly increase the scale of the company and increase the market share [1]. Horizontal M&A activities can enable companies to scale up, consolidate resources, and enhance competitiveness, thereby generating synergies and

maximising corporate value. However, there are also risks associated with M&A that can lead to acquisition failures.

A famous M&A event is on January 18, 2022, Microsoft officially announced its acquisition of Activision Blizzard for approximately \$68.7 billion in an all-cash transaction, valuing each share at \$95. This acquisition set a record as the highest-value deal in the technology industry and the third-largest acquisition in the entertainment industry. This action had a marked impact on competitor, for example, Sony, saw its stock price plummet by 13% the following day, causing significant shockwaves in the gaming industry.

Through this merger and acquisition case, combined with the internal and external environment analysis of the highly competitive game industry, this paper has a further understanding of the adoption of merger and acquisition strategy by enterprises. We used PEST analysis method to assess the macro-environment, coupled with commonly used internal environmental analysis and single-factor competitive environment analysis in strategic analysis. By conducting analyses from various environmental perspectives, we identify the opportunities and threats that Microsoft currently faces and consequently deduce the motivations behind Microsoft's actions. Furthermore, we explore the advantages and risks associated with this strategy, thereby offering insights of relevance for other enterprises.

2. Company Background

2.1. Microsoft Corporation

Since its establishment in 1975, Microsoft Corporation has consistently dedicated itself to the research and development of information technology. Its developed operating system, Windows, remains the most widely recognized. Subsequently, the company created the office software series, Office, and later ventured into the gaming industry, establishing Xbox. Through decades of relentless effort, Microsoft achieved a total revenue of \$211.915 billion in the 23rd fiscal year, marking a 7% increase compared to the previous year (22nd fiscal year), with a net profit of \$72.361 billion. In the entire fiscal year of 2023, the Xbox division of Microsoft generated a revenue of \$15.477 billion, approximately 7% of Microsoft's total annual revenue for that year, ranking as the fourth highest revenue-generating division.

Based on current analysis and available information, the development of Xbox's subscription gaming service, Xbox Game Pass, is intricately linked to this success. The substantial growth in customer subscriptions to this service has objectively contributed to Xbox's revenue. Presently, Xbox and its parent company, Microsoft, have become significant players in the gaming industry, capable of competing with market giants such as Sony and Nintendo.

2.2. Activist on Blizzard Inc.

Activision Blizzard is the name adopted by Activision after its merger with Vivendi in 2008. It currently stands as the world's largest third-party game developer and distributor. The company boasts a diverse portfolio of intellectual properties (IPs), spanning across various domains including PC and console titles like the "Call of Duty" series, "Overwatch" series, and notably, "World of Warcraft" and "Hearthstone," both of which are globally recognized game IPs, contributing significantly to the company's substantial revenue and renown.

In recent times, the company has also ventured into the mobile gaming sector, consistently surpassing \$900 million in revenue per quarter throughout 2022. This expansion has substantially broadened the company's audience, encompassing players who favour both PC and console gaming as well as those who engage in mobile gaming.

3. Strategy Background and Motivation Analysis

From a strategic perspective, we conduct an analysis that combines the external environment, internal environment, and competitive environment of the company to understand the motives and rationale behind Microsoft's decision.

3.1. External Environment

We used PEST analysis method as a strategic for macro- environmental analysis, It generally involves in the macro environment of the four major external environmental factors that impact the industry: Political and Legal, Economics, Social, and Technological.

3.1.1. Macro-environment

PEST analysis model is the most commonly used method to analyze the macro-environment. By analyzing the four elements, the macro-environment of the industry can be grasped as a whole [2]. Considering Microsoft try to transform to Game Operations Services and adapt to the development of new VR technologies, Microsoft decides to boost its growth in the gaming industry by acquiring Activision Blizzard, and we analyze it using PEST framework as follows.

Before Microsoft ventured into cloud services like Xbox Game Pass gaming subscription, the company primarily competed in the gaming industry through consoles, hardware, and other gaming companies. However, as computers became more prevalent and advanced, Microsoft's market share in the console space shrank significantly. Originally, Microsoft, Sony, and Nintendo collectively held over 90% of the market, but their combined market share has dropped from 49.7% to 21.2%.

In light of external factors such as political, economic, and cultural influences, the consumer market continued to expand. This compelled Microsoft to rethink its strategic positioning and core business in the gaming industry, shifting its focus from hardware to game operation services. Simultaneously, with the further development of VR technology, Microsoft, as a front-runner in internet technology, also aimed to leverage the gaming industry to proactively enter the VR technology space and make adequate preparations.

From the perspective of political and legal, due to the impact of the pandemic, various countries implemented isolation measures to prevent the spread of the virus. Since outdoor activities were limited, people's attention turned to the internet, creating an opportunity for the gaming industry to thrive. Additionally, Japan is home to many globally renowned gaming companies and offers substantial financial support and tax incentives for the gaming industry. For example, companies exporting gaming products overseas enjoy certain tax benefits. In contrast, the United States lacks similar support for the gaming industry, which creates environmental pressure on Microsoft's gaming development efforts.

From the perspective of economic factors, when Microsoft chose to acquire Activision Blizzard, it was during the early post-pandemic period when the global economy had been significantly impacted. However, despite the economic downturn, the prices of games from various manufacturers were continuously increasing, and the market was even expanding. Furthermore, as the economy gradually recovered, residents' income levels were expected to rise.

From the perspective of social and cultural factors, with the continuous development of the internet and the constant evolution of computers, there has been a significant increase in the number of internet users, making it easier for people to access computer games. As modern society experiences material growth, people's spiritual needs are also expanding. The captivating visuals, freedom of action, diverse gameplay, and rich imagination offered by games can satisfy various psychological needs.

Furthermore, from the perspective of technological factors, with the development of Virtual Reality (VR), the virtual reality gaming experience is gradually taking shape. Currently, major

gaming companies in the gaming market possess their own gaming IPs, production technologies, and a significant amount of intellectual property. This presents a significant external technological challenge for a company like Microsoft, which may lack gaming intellectual property.

3.1.2. Competitive Environment

Microsoft aims to bypass barriers, quickly enter the market, and seize opportunities in the gaming market by merging Blizzard. We conduct detailed analysis as follows:

In the competitive environment, Microsoft relied mainly on Xbox hardware and consoles for revenue in the gaming industry, without many of its own games. There were major players like Nintendo, Sony, Capcom, Bandai Namco, and numerous independent studios in the game production sector. The market competition was fierce, making it difficult for Microsoft to overcome the existing technological barriers to game development and gain a foothold in the nearly saturated gaming market. However, Activision Blizzard had entered the gaming industry market early, possessed a wealth of game IPs, and a substantial consumer base. This acquisition allowed Microsoft to bypass the technological barriers of game development, reduce costs and risks, and directly leverage Activision Blizzard's market share to enter the gaming market and seize more market opportunities.

Prior to Microsoft's announcement of acquiring Activision Blizzard, Nintendo and Sony had long dominated the forefront of the gaming industry. In fact, shortly after Microsoft's announcement of the acquisition, on January 31, Sony announced its acquisition of the game developer Bungie for \$3.6 billion. Even before this, in 2019, Sony had spent \$229 million to acquire Insomniac Games. Thus, the gaming industry has been characterised by intense competition.

Microsoft's Xbox division primarily focused on hardware development such as consoles and controllers, and it lacked a significant portfolio of valuable IPs. This weakened Microsoft's competitive position in the industry. Given the fierce competition in the market, Microsoft needed to enhance its competitiveness. Therefore, Microsoft urgently needs to enhance its competitiveness.

3.2. Internal Environment

For the internal environment analysis, Microsoft mainly have two motivations. First is to obtain operating synergy effect, second is to reduce the amount of liquid cash held.

3.2.1. Obtain Operating Synergy Effect

According to internal environment, Microsoft is mainly inclined to obtain the operating synergies of the acquisition. Operating synergies are mainly reflected by the business conditions of enterprises after M&A, such as patent barriers caused by acquiring patents through M&A, expanding market share and improving production efficiency [3]. Among them, Microsoft mainly focuses on resource complementarity and scale effect.

Firstly, it is advantageous for Microsoft and Activision Blizzard to form internal resource complementarity. Resource complementarity primarily relies on the resources of each company's respective strengths, which are combined with one another to make up for the inadequacies of each company's resources, thereby improving the overall efficiency and value of resources.

In terms of internal environment, on one hand, Microsoft has a strong financial base and has always been a giant in the computer system industry. In addition, Microsoft also has the development of cloud computing, artificial intelligence, and other technologies, thus having enough technical strength to support game development. On the other hand, Activision Blizzard's new game development requires a large amount of funding to support the development of more valuable game IPs, and also needs new technologies to improve game quality. Therefore, the two companies can fully complement each other. Microsoft lacks strong professional talent in game development and innovation, and also

lacks attractive game IPs that can attract players, which are its internal environment weaknesses. However, in terms of intellectual property, according to the data obtained, Activision Blizzard and its related companies have a total of over 1,100 patent applications. Among them, in the high level 90% of the patented invention ratio, more than 720 patented inventions have been authorized, and the patent layout is mainly focused on video, game, interactive, virtual reality and other related technical fields, which overlaps with Microsoft's technical development. This further adds value to the mutual utilization of resources between the two companies. At the same time, Microsoft has a broad layout in the gaming industry, with subsidiaries including Xbox game consoles, Windows PC game platforms, Xbox Game Pass subscription services, Xbox Cloud Gaming cloud game services, and Xbox Game Studios game developers. This also provides Activision Blizzard with a wider consumer platform.

Secondly, this acquisition can lead to economies of scale. They may also describe the economic advantages that show when higher volumes of output are produced with respect to smaller ones and that result in cost reduction per unit for that particular output, and for the same price of inputs [4].

Between 2018 and 2020, Microsoft acquired several game studios, including Obsidian Entertainment and InXile Entertainment. In 2020, Microsoft also sent \$7.5 billion to acquire ZeniaMax, which includes excellent studios like Bethesda. The recent acquisition of Activision Blizzard, a massive gaming industry, indicating a clear trend towards creating economic of scale.

Therefore, it becomes increasingly essential for both sides to create the synergy effect which may greatly affect the success in the long term. However, it should be noted that after the merger and acquisition, the integration and development of the market cannot be separated from the operation, so it is also necessary to pay more attention to the operation.

3.2.2. Reduce the Amount of Liquid Cash Held

Another important motivation is the reduce in amount of liquid cash help and to maximize shareholder wealth.

In terms of the financial situation of the internal environment, the acquisition of Activision Blizzard by Microsoft for \$68.7 billion was completed using cash payment in full. Microsoft's financial report for the 2021 fiscal year indicated that it had a cash flow of \$130 billion. In December 2021, the U.S Consumer Price Index (CPI) increased by 7%, significant risk of the U.S. dollar facing depreciation [5]. Therefore, it would not be benefit for Microsoft to hold a lot of cash, it does not help to gain revenue as it is not invested.

Holding a substantial amount of cash for further investment is a way to maximize shareholder wealth. Microsoft used its cash to acquire Activision Blizzard, not only recognizing the intrinsic value of Activation Blizzard but also optimizing its capital structure and reducing the idle cash on hand to engage in valuable investments.

4. Strategy Risk Analysis

4.1. Operating Risk

In the years leading up to Microsoft's announcement of the acquisition, Activision Blizzard faced numerous scandals. Female employees protested against various disrespectful behaviors towards women within the company, and they demanded the resignation of CEO Bobby Kotick. The U.S. Securities and Exchange Commission (SEC) also criticized Activision Blizzard for lacking procedures to collect employee complaints within its various business divisions from 2018 to 2021, and for failing to assess whether there were any significant issues requiring public disclosure. During 2016-2021, Activision Blizzard's execution of severance agreements in its normal business processes violated the SEC's whistleblower protection rules, leading to a decline in the company's stock price.

Additionally, due to operational issues, key executives at Activision Blizzard kept leaving, which means Microsoft will have to address these significant operational problems within its subsidiary.

4.2. Political Risks

Following the announcement of Microsoft's acquisition of Activision Blizzard, the company became embroiled in an antitrust lawsuit. This acquisition involved numerous countries and regions, with a staggering value of nearly \$70 billion, requiring approvals from regulatory agencies in various nations to proceed smoothly. Since both companies are based in the United States, they also faced antitrust scrutiny in U.S. courts. Microsoft has now received approval from U.S. courts and most of the world's antitrust agencies. However, this highlights the political and legal risks that large-scale cross-border acquisitions involving many countries and a substantial monetary value can encounter. These are issues that large corporations must be mindful of when engaging in mergers and acquisitions.

4.3. Financial Risk

Microsoft only uses cash to buy Activision Blizzard. Although it is to reduce cash flow, there is still a large financial risk.

Payment risk refers to the unreasonable payment method chosen by the enterprise when paying the consideration of merger and acquisition, which has a negative impact on the normal capital operation of the enterprise [6].

Microsoft has a huge cash flow. However, it cannot be denied that an all-cash purchase entails significant risks. Liquid assets are a crucial part of a company's financial stability, and cash flow is a reflection of a company's ability to meet its debt obligations and respond to emergencies. Hence, many companies opt for a combination of cash, equity, or other non-liquid assets when making acquisitions. Additionally, this acquisition by Microsoft involves a substantial premium, so it is imperative for the company to conduct a thorough valuation to avoid overpaying and potentially experiencing a loss compared to the value created.

5. Insights and Suggestions

5.1. Consideration of Environmental Factors

In this case, Microsoft's decision to acquire Activision Blizzard came at a time when the gaming industry was experiencing a peak period following the pandemic, indicating a favorable macroeconomic environment. However, the competitive landscape had become more intense, requiring stronger competitiveness. Additionally, Microsoft and Activision Blizzard had complementary resources, indicating a good fit in terms of the internal environment. It is crucial to carefully consider the external environment when making acquisitions, as failure to do so can lead to challenges in post-acquisition integration or overpaying for acquisitions, resulting in insufficient profitability from subsidiary companies.

5.2. Comprehensive Risk Management

Companies should engage in thorough risk management when considering mergers and acquisitions, especially concerning potential adverse impacts or legacy issues from the acquired company. To ensure a smooth post-acquisition integration, a detailed integration plan should be developed, including personnel consolidation, cultural integration, technology integration, and more, to maximize the synergistic effects of the acquisition.

5.3. Diversification of Acquisition Funding to Mitigate

Financial Risks Microsoft's decision to use all-cash payment for the acquisition of Activision Blizzard posed a threat to the company's financial position and reduced liquidity. While Microsoft has a strong short-term debt repayment capability and significant cash flow, this may not be feasible for other companies to emulate. Each company must tailor its acquisition strategy to its own financial situation to minimize risk and ensure stability.

6. Conclusion

Three years of pandemic has allowed the game industry to flourish, and in this article, we take Microsoft's acquisition of Activision Blizzard as an example to analyze its acquisition strategy. First, we analyze Microsoft's motivation for acquiring Blizzard from the external environment and internal environment. Second, we analyze the various risks of Microsoft's acquisition of Blizzard. Finally, we put forward suggestions to the companies that are interested in mergers and acquisitions.

References

- [1] Ai Xin. *A Study on the Cooperative Effect of Horizontal Merger*. 2020. Zhongnan University of Economics and Law, MA thesis.
- [2] Wang Yishuai, Zhu Manyang, Yang Fan. *The Analysis of the Current Situation of Agricultural Macroscopic Environment in Hebei Province Based on the PEST Model*. *Tianjin Agricultural Sciences*, 2015, 21(3): 63-65.
- [3] Zhao Xuanming, Ji Mingyue. *Analysis on the motivations and synergistic effects of Internet enterprise M&A, taking Alibaba's M&A of Eleme as the example [J]*. *Financial Management*, 2020(05), pp.54–58.
- [4] M. Bellandi, "Economie di Scala e Organizzazione Industriale," *Il Mulino*, Bologna, 2007, p. 29.
- [5] Chen Guanyu. *Research on the Realization Path of Technology and Management Innovation of Small and Micro Enterprises Empowered by Digital Technology*. *Jiangsu Commercial Forum*, 2023, 2, 118-119.
- [6] Pei Wu, Bulei Yu. *Risk Analysis and Preventive Measures of Enterprise Merger and Acquisition -- A Case Study of Suning Tesco's Merger and Acquisition of Carrefour*, *Frontiers in Business, Economics and Management*, ISSN: 2766-824X / Vol. 10, No. 2, 2023