

SuMi's Coffee Break Column – Why Japan's Gaming Industry is One to Watch

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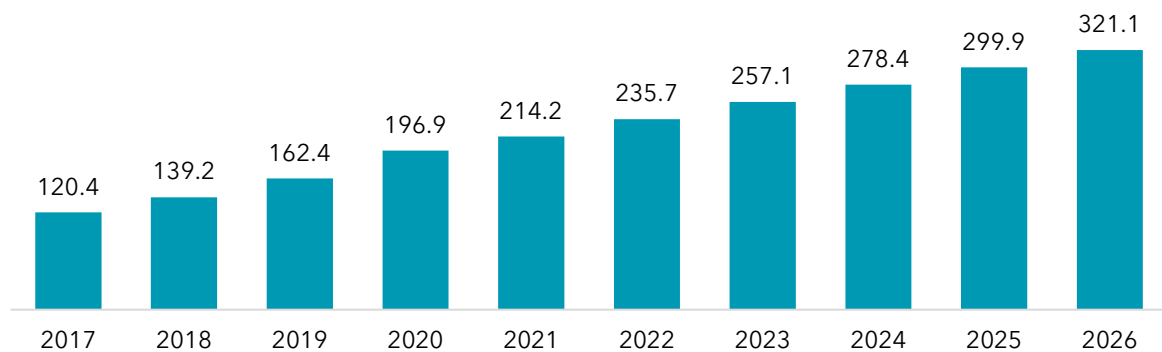
Without a doubt, Japan is a market leader within the gaming industry, home to industry behemoths such as SONY, NINTENDO, BANDAI NAMCO, KOEI TECHMO, SQUARE ENIX, and SEGA to name a few. What makes Japan such a frontrunner within the gaming industry? And what growth potential is there in this industry? In this column, I would like to provide an overview of the global gaming industry, and introduce the strengths of Japanese video game providers and the stocks I am investing in within my Japan Quality Growth strategy.

If you are an avid gamer, chances are you have interacted with a game created by a Japanese studio. Whether it is the Game Awards' 2022 Game of the Year Elden Ring, the highly-acclaimed Final Fantasy series, or The Legend of Zelda – Tears of the Kingdom – dubbed one of the greatest video games of all time, Japanese game studios have a titan reputation within the industry. With a long-standing history of game development and strong infrastructure, the Japanese games industry continuously innovates and captivates gamers worldwide. The gaming industry certainly has a bright future ahead and is one sector is one to watch – especially in Japan.

How big is the gaming industry?

The video game industry boomed during the pandemic as people found themselves isolated at home and with more free time on their hands. With the expansion of online gaming, players can socialise with other players across the world in an interactive virtual setting. These online platforms saw an influx of players seeking social interaction during the pandemic, providing a boon for gaming companies. According to a report by PwC¹, the gaming industry is tipped to maintain its recent rapid growth and could be worth \$321 billion by 2026 (Figure 1). Additionally, PwC forecasts that global videos games will represent 10.9% of entertainment and media spending by 2026, up from 6.1% in 2017, highlighting the huge growth opportunities within the gaming industry.

Figure 1: Total Global Video Games Revenue (US\$bn)

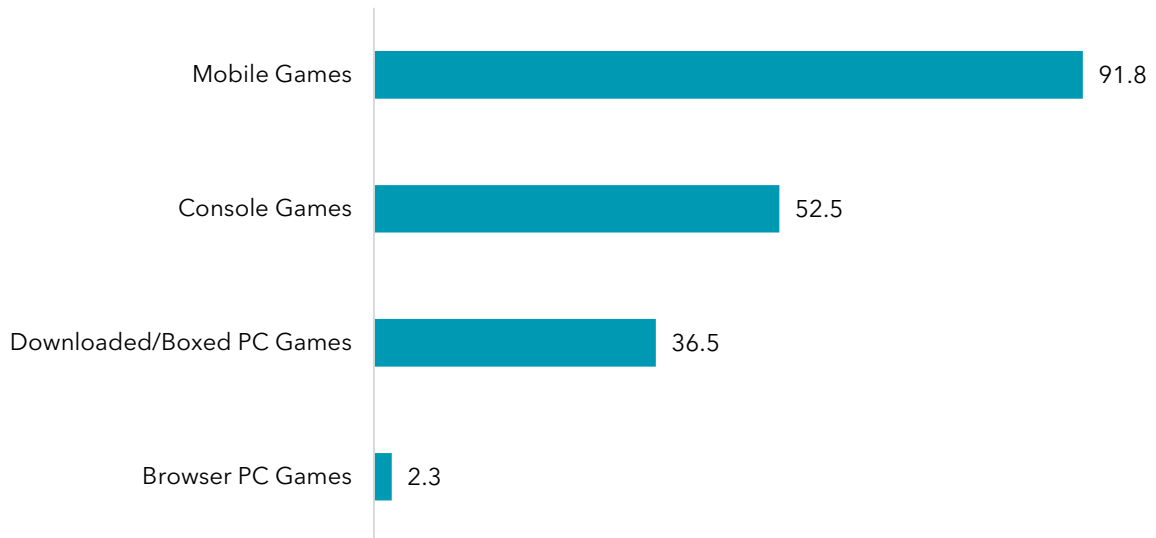


Note: 2021 is the latest available data. 2022-2026 values are forecasts.

Source: PwC's Global Entertainment & Media Outlook 2022-2026, Omdia

The gaming industry itself is segmented by gaming platforms including mobile gaming, console gaming and PC gaming. As of 2022, mobile gaming has brought in the most revenue, encompassing 50% of global gaming revenue (Figure 2).

Figure 2: Global Games Revenue by Segment in 2022 (US\$bn)



Note: Revenue includes consumer spending on games: physical and digital full-game copies, in-game spending, and subscription services. Advertising is excluded from mobile revenues. Estimates exclude taxes, secondhand trade or secondary markets, advertising revenues earned in and around games, console and peripheral hardware, B2B services and the online gambling and betting industry.

Source: Newzoo (as of May 2023)

Additionally, gaming IPs offer a whole realm of spin-off and tie-in opportunities for firms including merchandise and live action adaptations. A recent example of this can be seen in the huge success of The Super Mario Bros. Movie produced by Universal Pictures, Illumination and Nintendo. Movie franchises have also spawned the creation of successful videogames utilizing popular IPs such as Marvel's Spiderman. With the new release of Sony's "Spider-Man: Across the Spider-Verse" movie, it can be expected that this will drive excitement for the latest Spider-Man video game, "Spider-Man 2", which is set to be released as a PlayStation 5 (PS5) exclusive on 20 October 2023. Through the successful crossover of video games and films, it is clear the video games industry shows no sign of slowing down and is expected to grow substantially in the future.

What makes Japanese companies stand out?

While it has been said that Japan is lagging behind when it comes to digitalisation, Japan's gaming industry bucks this trend. But what are the driving forces behind Japan's dominance in the industry?

1. Unique Storytelling - *driven by a passionate and creative community*

Japanese games have long been a favourite among gamers for their unique storytelling. Popular gaming franchises such as Final Fantasy, Persona and The Legend of Zelda are known for their detailed storylines and developed characters which hook players in. Additionally, the Japanese style of storytelling has proven popular globally and one in which companies take pride. Notably Yosuke Matsuda, former president of Square Enix, advised Japanese game developers not to imitate Western studios, noting that the Japanese design element of the games from visual to audio affects are what makes the games so successful.² This sentiment has been echoed by game designer Hironobu Sakaguchi, creator of the Final Fantasy series, who said at the Monaco Anime Game International Conferences 2023 that he "didn't feel the need to be inspired by [Western games]...[and] that cherishing [his] Japanese cultural background is what attracts people towards [his] games in the first place."³

2. Innovative Gameplay - *made possible by leading the development in gaming consoles*

Japanese games studios have also captivated gamers with their focus on developing innovative game play mechanics, made possible by leading the development in gaming consoles. A key example comes from Nintendo - a company that has put fun at the forefront of its game development. Nintendo has long lead innovation within the games industry, with the introduction of dual screens on its Nintendo DS and the hybrid design of the Nintendo Switch. Additionally, as the creator of its own console and games, Nintendo is able to grow and develop games with their consoles' capabilities at the forefront.

Sony's dominance in the console market also provided a strong foundation for Japanese games studios. Square Enix's Final Fantasy has been hailed as the game series to put Japanese role-playing games on the global stage. As noted by Hironobu Sakaguchi, the Final Fantasy series owes much of its early success due to the ease of access Japanese games studios had to Japanese developers of gaming software and hardware. According to Sakaguchi, "we could ask Nintendo or Sony directly in Japanese. This is why - I realize it might be impolite to say this - Japanese games were of a higher quality at the time. As a result, Japanese games were regarded as more fun."⁴ With this connection, Square Enix's Final Fantasy XII was able to introduce CG. The high quality of infrastructure present in Japan has long benefitted Japanese game developers, and while this has changed over time as PC gaming has risen in popularity to rival consoles, this foundation has undoubtedly contributed to the innovation within the Japanese games industry.

3. Advanced DX (Digital Transformation) - *as seen in the use of cloud infrastructure and simultaneous releases*

Japanese games have also found success through their advanced use of digital transformation. In a recent article by Business Insider, Google's Director of Game Industry Solutions, Jack Buser, notably said that Google has learned a lot from Japan when it comes to developing global strategies by utilising the cloud.⁵ A recent trend within gaming is the pivot towards cross-platform gaming - i.e., games that can be played on multiple platforms

including PCs, consoles, and smartphones. This exposes players to an even wider player base, as they can connect online with people using different platforms. As noted by Mr Buser, Japanese video game makers like Bandai Namco work on games for multiple platforms at once, allowing them to implement their knowledge from one platform to another. As cross-platform gaming has increased in popularity, Japanese games makers have embraced this and invested in their use of cloud infrastructure.

Additionally, Japanese games studios are increasingly embracing simultaneous global releases, as seen with the release of SEGA's *Lost Judgment* in 2021.⁶ Rather than first releasing in Japan and then shipping localized editions later, Japanese games studios are increasingly favouring a worldwide release to maximize impact and interest in their games. As the console market is considerably larger in the US, global releases of Japanese games make sense economically for publishers and benefit international gamers who no longer have to wait for Japanese games to be translated after release.

What are our top gaming stocks?

Now I would like to introduce the gaming stocks held by my Japan Quality Growth Strategy.

Bandai Namco Holdings (7832.T)

Bandai Namco Holdings is a major entertainment and amusement services provider in Japan. The company offers entertainment built upon a close and collaborative connection with its fans which fills them with a sense of satisfaction. With the purpose of delivering 'Fun for All into the Future', Bandai Namco aims to provide a fun and moving experience to people all over the world, and seeks a future filled with smiles and happiness. We included Bandai Namco in the portfolio as we value its strategy which maximizes the value of its IPs through utilizing their global appeal and unique characteristics to offer the best possible products and services at the optimum timing to the most effective regions. Bandai Namco has been expanding its global presence and will open its first overseas store in London this July.⁷ The Bandai Namco Cross Store in Camden Market will consist of six shops, offering consumers not only merchandise such as capsule toys but also areas for game events. In addition to the company's plans to develop a movie and a game about "SAND LAND" by Dragon Ball creator Akira Toriyama this summer, and I expect the company to grow through its expert use of synergism to drum up demand for its products.

Square Enix Holdings (9684.T)

Square Enix, a video game content provider, offers top-tier entertainment with its content and services which stem from innovative ideas and expressions. The company's philosophy is: 'To spread happiness across the globe by providing unforgettable experiences'. I included Square Enix in the portfolio as I anticipate the improvement of its business profitability thanks to the progress of its digital sales and the strengthening of its game development capabilities. The company's popular *Final Fantasy* and *Dragon Quest* titles have the advantage of continuing to expand their user base. It has been more than 30 years since their first titles were released, and players who were children at the time are now in their 40s and 50s. I will be watching to see if the company can grow by continuing

to produce titles that can expand its user base across generations, such as these older users and today's children.

Sony Group (6758.T)

Sony Group offers moving experiences which enrich the mind and make creators' dreams a reality. The company's purpose is to 'Fill the world with emotion, through the power of creativity and technology.' Sony's management style focuses on 'getting closer to people', and the company diversifies its business through its various business sectors including gaming, media content (such as movies and music), its electronic brand (from TVs to cameras) and sales (finance). The Japan Quality Growth Strategy included Sony in the portfolio as we see the value in its business strategy, which aims to expand its customer base from 160 million to 1 billion active users. Sony's customer base is expanding toward this goal, and, in fact, Sony's PS5 is expected to reach 63.5 million units by the end of March 2024. We believe that the PS5 will create synergy with FINAL FANTASY XVI, a PS5 exclusive, which Square Enix HD released last month, and will become increasingly popular, enabling Sony to realize further growth.

As noted above, the gaming industry continues to expand, and Japan's gaming industry is in a prime position to capture these growth opportunities. For this reason, I believe these gaming stocks have a solid place in the Japan Quality Growth portfolio.

About Writer



Tatsuya Suzuki, Chief Portfolio Manager - Japan Quality Growth Strategy

Tatsuya Suzuki is the chief portfolio manager of the SuMi TRUST Japan Quality Growth strategy and has been since the inception of the strategy in 2015. The strategy is an all-cap strategy based on a bottom-up approach. The portfolio is benchmark agnostic and highly concentrated with around 30 stocks. Currently he is managing over 500 million US dollars in the strategy, which is available as the Irish domiciled SuMi Trust Japan Quality Growth fund. Tatsuya is a graduate of Waseda University with a BA in law. He is a Chartered Member of the Securities Analysts Association of Japan and was a member of a corporate disclosure study group within the Securities Analysts Association of Japan from 2006 to 2010.

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