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Epic Games Primer (Pts II+III): Epic Games Store & Epic Games Publishing — MatthewBall.vc

May 18 Written By Matthew Ball & Jacob Navok

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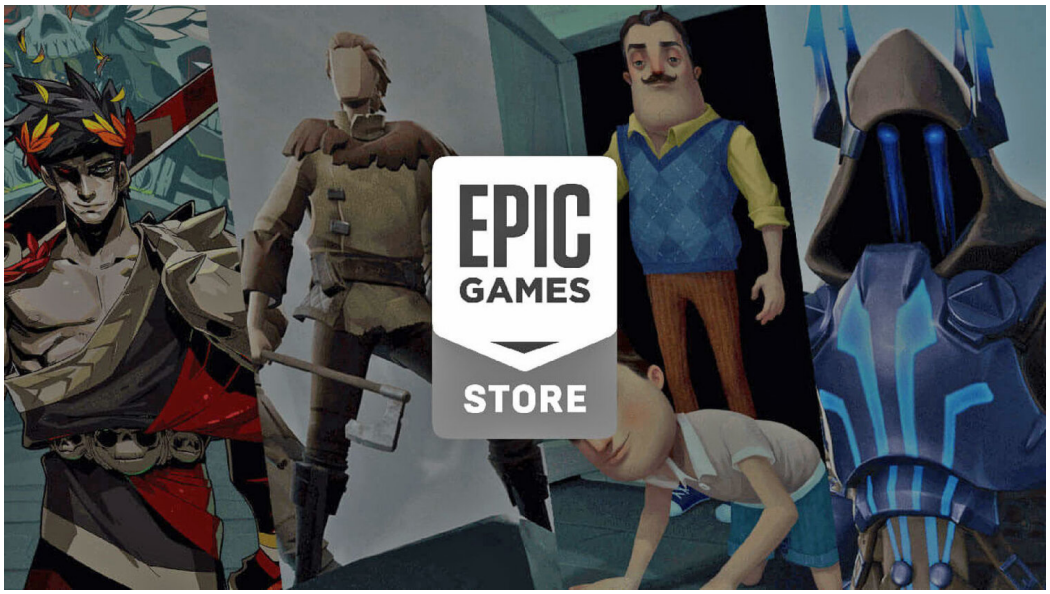

Recapping the 'Epic Games Primer' and Epic Games Flywheel

The purpose of this primer is to walk readers through each area of Epic Games. Specifically, we detail why it exists, how it works, what it hopes to achieve, why it matters, and how it will strengthen Epic Games overall. The first part focuses on the Unreal Engine. This part discusses the Epic Game Store and Epic Games Publishing.

The Epic Games Primer, Part II: Epic Games Store (2019–)

What Are Game Stores?

Today, there are three core platforms for video games: consoles, PCs, and mobile devices.

Game consoles have been "closed platforms" since the late 1980s, which means a game publisher must receive approval from a hardware manufacturer/platform (e.g. Nintendo, Sony, Microsoft) to release games for its systems. This primarily means paying the platform owner the licensing fee for every copy sold, no matter which independent retailer sold it. For example, Activision Blizzard would owe Sony 30% for every *Call of Duty* sale from GameStop, Walmart, or Amazon.

Today, however, more than 50% of game sales occur digitally. And the only way to buy a digital game for the major consoles is through the platform's proprietary store (e.g. the PlayStation store, Nintendo Online). These stores also manage all secondary purchases, such as DLC content, in-game currency, and outfits.

Mobile ecosystems are similar. On Apple's iPhone and iPad, all games (like all apps) must be installed and paid for through the App Store. Android users technically don't need to use Google's Play Store, but avoiding it is effectively impossible as "side-loading" apps require changing custom settings and ignoring security warnings (often on a recurring basis).

These first-party stores take 30% of all one-off transactions and 30% of subscriptions during the first year, after which the rate drops to 15%. In exchange for the revenue share, console makers and mobile

platforms secure accounts, process transactions (and returns), handle entitlements (e.g. access rights and paywalls), and deal with the mess of customer service. They also market their platforms ("there's an app for that") and manage the operating systems that run games. Most importantly, these platform owners get their hardware into consumer hands, which thereby gives game makers a customer base in the first place. This is particularly tricky in console gaming as hardware such as a PlayStation or Xbox are typically sold at a loss for Sony and Microsoft.

The PC ecosystem evolved differently than both consoles and mobile. Unlike PlayStation or Apple, Microsoft owned only the operating system, not the hardware. In addition, Microsoft wasn't in the business of selling third-party software until 2012. Instead, it focused on selling its operating system, Windows, and key first-party software like Microsoft Office. This means anyone could develop and distribute their software/apps directly to the customer with no royalties paid to Microsoft — games included.

At the same time, most PCs don't have the space to install numerous games. A consumer might download dozens of productivity applications and documents, but they could only download a few games at a time. And the process of downloading these apps, uninstalling them, reinstalling them when desired, shifting them to a new PC, etc., would all mean managing offline hard drives, multiple credentials, credit card forms, websites, and so forth. Worse still, many online multiplayer titles, such as Valve's *Counter-Strike*, required all players to have the same, most-up-to-date version of the game. It was annoying enough to download a single large game file in the days of slow Internet. These games, meanwhile, forced a player ready to play a game to first go back to the publisher's website, find the appropriate update for their device, download the file, and then install it.

To address this customer problem, Valve launched a digital games store for Windows in 2003 called Steam. And to launch this store, Valve leveraged its hotly anticipated game, *Half Life 2*. Specifically, Valve made it so that the *only* way to play *Half-Life 2* was by first downloading, installing, and setting up Steam. Although players initially resented the extra effort required to play a game they paid for, they quickly embraced its ease of use, social features, sales, and ability to highlight the best undiscovered games. And from day one, the store would automatically patch all installed games; no longer would players get home to find out they needed to wait and work to play.

Over time, Valve continually invested in additional online services for Steam, too, which were collectively called Steamworks. For example, it used the Steam account system to create an early "social network" of friends and teammates that any game could access. This meant games didn't need to ask users to search for and re-add their friends (or rebuild their teams) every time they bought a new game. Steamworks' Matchmaking, meanwhile, enabled developers to use Steam's player networks to create fair and balanced online multiplayer experience. Steam Voice then allowed players to speak in real time.

All of these services were provided free to the consumer and game publishers, at Valve's expense. These services would even be offered to games not sold on Steam - e.g. 'Call of Duty' at GameStop - and which therefore generated no direct revenue for Steam. However, this required a player to install and run Steam for as long as they wanted to play the game. This delivered more customers and data to Steam and made it harder for players or publishers to leave. It also meant that if a third party e-store sold a game, such as Amazon, they'd collect only the revenue from that player's purchase, not the player's playtime - that would go to Steam.

Like most distribution platforms, Steam took a 30% transaction fee. Though unlike PlayStation or the iPhone, game publishers could still get their games onto consumer PCs through other stores or their own store.

(Note that no party, Steam included, has been able to launch their own digital store on Apple or Nintendo devices, PlayStations, Xboxes, or Androids. It's not even possible to try.)

The Hegemony of Steam's PC Store

Throughout the 2000s and 2010s, Steam continually grew its share of the PC gaming market (which itself continued to grow). By 2015, the company was reportedly generating more than $2B per year in profit — more than $6MM per employee. Some argue Steam's success building a digital, auto-patching storefront is why PC gaming is so vibrant today; before it launched, many top publishers had altogether stopped supporting or investing in PC games to instead focus on the growing console segment.

Steam's success led many publishers to try and launch their own digital stores, each hoping to capture the 30% fee paid to Valve and retain full ownership of their player and their data. This included EA's Origin and Activision Blizzard's Battle.net.

In addition, several non-publisher stores emerged. Amazon, for example, undertook a costly effort to grow its market share in game software. For years, Prime customers received $10–20 discounts on dozens of $40–60 games — even those not playable on PCs. In 2012, Microsoft launched its own Windows Store, which was natively integrated into all Windows PCS and often had exclusive PC distribution rights to a select number of Microsoft's Xbox exclusive titles.

Although several successful games launched on PC without using Steam, such as *Fortnite* and *League of Legends*, no viable competitor emerged. After more than six years releasing its PC games exclusively via EA Origin, EA announced in 2019 that its titles would finally be available on Steam. Many of Activision Blizzard's most popular titles, such as *Call of Duty*, were never exclusive to Activision Blizzard's Battle.net in the first place. Amazon and Microsoft, too, have struggled to dent Steam's share.

Steam's resilience reflected the enormity of its head start. By the time any plausible competitors launched, the platform had a 75% share of the PC market and an even greater share of playtime. This made it hard for any publisher to withhold its content and for any new store to attract customers. In addition, Valve's Steamworks services produced considerable network effects that brought players to their platform and made it even harder for a publisher to pull their games.

For example, many game achievements (e.g. such as a digital trophy or badge) and histories (e.g. life-to-date death-to-kill ratios) were on Steam. Although these achievements could sometimes be shifted from Steam to a game if a developer desired developer desired and built the requisite functionality, there was no way to take all (or even most) achievements across all games to another store.

In addition, Steamworks' player networks and matchmaking services mean that if a player switches stores, they need to rebuild their entire friend and teams lists. This is true even if they moved only a single game (e.g. *Call of Duty*) or only played one in the first place. Similarly, we can consider the example of team-based communications. A "squad" of three players can open Steam and talk, then decide to play *Call of Duty* together and continue talking to one another. In addition, they can then play a fourth friend playing *Call of Duty* via Activision Blizzard's store. But to talk to this player, they need to use a separate communications app like Apple's FaceTime or Discord. This naturally concentrated players.

While many players remained happy with Steam throughout the 2010s, game publishers became increasingly frustrated. The store's 30% rate was particularly controversial. Although 30% is the standard for digital stores, Valve, unlike Apple and Sony, didn't build or sell game hardware, nor did it build game-playing operating systems like iOS or PlayStation's Orbis OS.

Part of this pushback, too, reflected the ongoing commodification of Steam's core offerings: digital distribution and online gaming services. Steam launched the same year as Apple's groundbreaking iTunes Store but offered far more complicated content (multi-gigabyte installable gamefiles and updates v. multi-megabyte one-time downloads) plus the ever-growing suite of Steamworks products.

In the time since, however, it has become relatively easy to launch a digital store. Companies like Digital River, for example, offer whitelabel storefront services. In addition, many gamers have begun substituting Steam's services, such as its live chat and player networks, with third-party apps and tools. It doesn't matter if *Call of Duty* from Steam can't talk well to *Call of Duty* from Battle.net if the entire team is chatting through Discord.

The Epic Games Store Strategy

For years, one of the loudest critics of Steam's 30% fee was Epic Games CEO Tim Sweeney.

By his estimates, the actual cost of digitally distributing a game was 5–7%, including credit card processing fees, customer service, bandwidth and fraud, and so forth. And while Steamworks added value, it wasn't sufficient to justify a 5–6x markup of direct costs (notably, Valve claims Sweeney's estimates are too conservative). In addition, Valve, unlike Sony or Nintendo, didn't need to cover money-losing hardware or operating system investments. Accordingly, the store was unfairly depriving developers — those responsible for making games in the first place — of the profits they were owed and which they needed to reinvest in their businesses.

Sweeney's ire extends to other non-hardware gaming platforms, too. When Microsoft launched its own Windows Game Store, which automatically loaded onto all Windows PCs, he stated that while he supported competition in game stores, he feared Windows would begin to "force-patch Windows 10 to make Steam progressively worse and more broken" (this hasn't happened).

Sweeney has also publicly called Android a "fake open system," noting that while users *can* download apps from outside the Google Play Store, and even download third-party app stores, Google makes this

incredibly difficult and effectively warns customers against doing so. Sweeney considers Apple, which doesn't allow for any downloads outside the App store, "even worse."

After years of criticising Valve, Epic Games decided to launch its own PC and Android store in late 2019. And just as Valve used the launch of *Half-Life 2* to launch Steam, Epic chose to leverage *Fortnite*. But while *Half-Life 2* launched through Steam, *Fortnite* was already in market and installed on tens of millions of PCs and Android devices globally. Accordingly, Epic chose to turn the "Fortnite Launcher" app into the "Epic Games Store" (EGS) via update, through which *Fortnite* players would then access the game. This meant that within days, EGS was on tens of millions of devices globally.

To Sweeney's word, the Epic Games Store didn't just offer publishers another outlet for their games. It also offered substantially greater profits. Specifically, Epic would take only 12% commissions rather than the standard 30%. And despite charging 2.5x less than Steam, Sweeney argued Epic was still generating 50% profits per sale.

Notably, this 12% rate is available to any publisher, even if they didn't use Unreal. But in the event a publisher's game does use Unreal, Epic waves the Unreal licensing fee (typically 5%). This means that the net cost of distribution through EGS is only 7% — barely above EGS's costs.

Game distribution and game engine licensing are obviously different services, and therefore it's fair for Epic to charge. However, Sweeney believes that low fees are critical to the health of the independent game community and prefers not to double dip. And to seed its store beyond *Fortnite*, Epic Games Store also began to offer (incredibly) lucrative deals to publishers in exchange for exclusive distribution rights to its games (some of these rights were just for a few weeks or months).

Epic's EGS strategy is perhaps best explained by what it lacks. If you wanted to build a digital store in 2019, the list of core features wouldn't be hard to devise. However, EGS is missing many of the "things" the standard spec sheet would consider essential. For example, there's no shopping cart and no discount codes. All games must be bought immediately on their sale page, at the full price, and only one game can be bought at a time. To quote Sweeney, "If we had one more engineer on the team with the skills to build a complete shopping cart (supporting coupons and regional pricing and discounts and other custom Epic features) we'd still want them to work on the more essential and time-critical features." EGS really isn't the point; the rate is.

EGS's Struggles

EGS's missing features, though small, reveal one of the challenges with the EGS model: it offered developers greater profits but frustrated the consumers that would be required to deliver them. To seed its store, Epic also bought exclusive distribution rights to many top games. This meant developers would receive both lucrative upfront payments plus greater shares of later revenues.

However, most PC gamers were either happy with Steam or at least happy to have most of their games accessed via a single store. Fragmenting their game purchases and player networks across two (or one more) stores, let alone one with fewer features, was seen as an annoyance. In addition, many saw the move as little more than an Epic cash grab. It is understandably hard to convince consumers to change stores for the benefit of the ecosystem.

Making matters worse, many consumers expected that reduced store fees would lead to lower prices for them, not just greater profits for developers. Why couldn't both groups benefit from Epic's lower store fees?

However, Sweeney has alleged that Steam's distribution agreements contain "Most Favored Nations" clauses (and other commitments) that made this essentially impossible. Specifically, he suggests that in order to sell a game through Steam, publishers agreed that Steam would always have the "lowest price available for sale." This meant that if a publisher wanted to drop their price on EGS, they'd have to do so on Steam, too (and, of course, Steam's 70% fee would still apply). This would save consumers money but result in substantial revenue decreases for the publisher. The alternative was to remove the title from Steam altogether, but given its dominance (an estimated 70%+ market share) and EGS's nascent status (<5%), this was impractical for anyone not receiving store exclusivity payments from Epic (which were, by definition, intended to compensate for sales that would have happened if the game were on Steam).

(It should be noted that the "price parity" clause Sweeney refers to is not in public documentation; he alleges that it is located instead in private developer agreements. There was a change in September 2019 to Steam developer agreements that required release parity, but this change is unrelated to pricing and took place seven months after the above Tweets).

Most of the attention paid to EGS focused on its PC store and battles with Steam. However, EGS also launched on Android, where it was the exclusive home of *Fortnite* on the platform. Notably, Android is the only gaming platform after PC where it's even possible to launch a digital store or offer apps outside of the platform owner's own store. And as was the case on PC, Epic offered an 88/12 split, versus Google Play's 70/30. But ultimately, the difficulty of driving installations outside the Play Store, which required users to change their settings and approve several security exceptions (often on a recurring basis), led Epic to drop these plans after a year and a half. In April 2020, the company announced *Fortnite* would shift to the Google Play Store. This meant Epic would share 30% of Android-based *Fortnite* revenue with Google and could no longer offer the Epic Games Store.

> *"After 18 months of operating* Fortnite *on Android outside of the Google Play Store, we've come to a basic realization…. Google puts software downloadable outside of Google Play at a disadvantage, through technical and business measures such as scary, repetitive security pop-ups for downloaded and updated software, restrictive manufacturer and carrier agreements and dealings, Google public relations characterizing third party software sources as malware, and new efforts such as Google Play Protect to outright block software obtained outside the Google Play store." - Epic Games*

The Value of EGS to Epic

Sweeney has been vocal that EGS was likely to deliver either of two outcomes, both of which he'd consider a success. First was that EGS steadily stole market share from Steam and others, thereby shifting billions of dollars in profits per year from stores to the actual creators of content. Second, Valve would drop its rate from 30% to 15%, thereby leaving EGS with no advantages and many disadvantages (fewer users, fewer features, fewer games) but still billions of dollars in profits per year from stores to the actual creators of content. Furthermore, Sweeney has said "if Steam committed to a permanent 88% revenue share for all developers and publishers without major strings attached, Epic would hastily organize a retreat from exclusives (while honoring our partner commitments) and consider putting our own games on Steam." This would leave EGS with no pricing nor content advantages.

Notably, Valve improved its revenue share rate only three days before the official launch of Epic Games Store (due to its publisher negotiations, Valve would have been aware of its launch months earlier). Specifically, games would pay only 25% commissions after $10MM in revenue and 20% after $50MM. The platform even announced it would backdate eligibility by two months. Of course, many found this approach regressive. The richest games would pay the lowest "app store taxes," and small independent developers would pay the greatest. Sweeney, meanwhile, has outright refused such sliding scales, going so far as to say even Epic and Fortnite will not accept privileged deals with the likes of Amazon and Apple unless they're made available to all.

But beyond its impact on the gaming ecosystem, even a modestly successful EGS offers enormous benefits to Epic. Mostly obviously, the store allows Epic to (1) substantially grow the number of active users in its player network; (2) grow the size of the Epic ID player/social graph; and (3) increase the total Epic-related playtime, data, and spend per *Fortnite* user. In addition, Epic can use the third-party games on its store to retain and delight every player in the Epic network. Each month, for example, Epic gives active EGS users a free game.

EGS also substantially grows Epic's influence across the gaming ecosystem. Through Unreal, Epic has already made many of the world's best game developers its customers. EGS then allows Epic to make those who play these games Epic customers, too. What's more, Epic even gets to make the players of games not based on Unreal its customers! This bookend model then allows Epic to "fill in" the middle with additional services (see next section).

Similarly, EGS provides Epic with increased visibility into which games, features, and experiences players are enjoying, as well as a view into the future pipeline of games not based on Unreal. This sort of data isn't unique — Sony, Valve, Apple, and so forth also have this data — but it would be new for Epic. Gaining such information should, in turn, help inform investments in other parts of Epic's platform.

Finally, operating a store that consolidates entitlements (what gamers have access to) under a single account (Epic ID) with a social graph (e.g. friends list) and through a common platform (Epic Games Store) makes it far easier for Epic to drive interoperability and multi-game experiences. More on this later.

The Epic Games Primer, Part III: Epic Games Publishing (2020–)

What Is Game Publishing?

Games are made by developers for players. Between these two groups isn't just a retailer/store, but also a publisher.

Publishers finance the production, marketing, and distribution of a game and often provide their proprietary engine, too. In exchange, they've typically received the vast majority of the profits from a hit game, and in most cases, the underlying IP copyright as well.

These terms are onerous, but they also reflect the difficulty of actually getting a game into a player's hand in the physical media era. Manufacturing physical cartridges and discs was costly and laborious, as was getting this merchandise to thousands of retailers and then repeatedly collecting payments from these many retailers.

However, most independent developers don't need to release their games on physical media. The biggest games, such as *Red Dead Redemption 2*, which retails for $60, have both the mainstream appeal and the price point to justify nationwide marketing and costly manufacturing. But indie and mid-level games can reach most of their addressable market (highly consumptive gamers) via digital-only distribution. Furthermore, a $20 game can't generate a profit via physical media that costs several dollars to make and ship and is sold by a physical retailer that takes $10.

This has led many to "self-publish" their games to Steam or Epic Games Store, which can be done at nearly no cost and can ensure a greater share of financial upside. Of course, developers still need to fund their games' development, attract players, and finance live operations. However, the availability of funding has grown considerably. Dozens of venture capital firms, for example, now invest directly in studios. Platforms such as Xbox Game Pass also offer game financing to developers, while stores such as Epic Games Store also offer minimum revenue guarantees to high potential developers. This has, in turn, led publishers to now offer much better deal terms to developers and emphasize their ability to build a player base over getting copies in stores.

The Epic Games Publishing Strategy

Epic has been publishing its own games, such as *Fortnite*, for years. But in 2020, it announced a new initiative to publish the games of independent developers — and at what's essentially the best possible terms. Specifically, Epic would fund up to 100% of development costs, including employee salaries, and split profits 50/50 following cost recoupment. In addition, developers would retain "total creative control" and 100% ownership of their IP.

It's not yet clear whether Epic Games Publishing (EGP) requires a developer to build its game on Unreal and/or distribute its game through EGS (at minimum, it seems likely EGS will have a temporary exclusive window and must be at least *one* of the stores selling an EGP title). After all, EOS has no such restrictions or Unreal/EGP-only perks.

It's also unclear how the use of Unreal and/or EGP would fit into recoupment. As mentioned earlier, Unreal typically charges a 5% royalty on revenue, while EGS charges 12%. But if a game based on Unreal is published to EGS, Epic waives the Unreal licensing fee. Game distribution and game engine licensing are obviously different services, and therefore it's fair for Epic to charge. However, Sweeney believes that low fees are critical to the health of the independent game community and prefers not to double dip. It's similarly possible that EGP publishers have similar and substantial discounts for Epic's other paid services.

Most important, however, is Epic's ability to promote EGP releases in the Epic Games Store and via *Fortnite* integrations. *Borderlands 3*, for example, is an Unreal-based game that was published by 2K and was exclusively available via EGS for the first six months after release. Leading up to the game's launch, part of *Fortnite*'s map contained a mini-virtual world that, when entered, transformed into the *Borderlands* universe — inclusive of its aesthetic and items.

Expect Epic's publishing division to enlist star creators, similar to Netflix. Indeed, the first three developers signed to EGP are GenDesign (makers of *The Last Guardian*), Remedy (*Control*, *Alan Wake*, *May Payne*), and Playdead (*Inside*).

The Value of EGP to Epic

Most obviously, EGP allows Epic to financially benefit from the success of hit games. It also gives Epic an even greater look at the future pipeline of games from top developers and adds to its growing one-stop-shop suite of game making tools, resources, and functions.

What's more important, though, is how EGP can help pioneer and accelerate newer Unreal-based technologies and experiences. Epic doesn't creatively control any EGP titles (in fact, the company is

clear they will not co-opt or steer developers). However, EGP developers will potentially benefit from greater insight into forthcoming Unreal capabilities, as well as additional access to the Unreal development teams. This should lead to more, better, and earlier advances in Unreal — without Epic needing to manage the end-to-end creative experience themselves (as was the case with *Fortnite*). In this sense, the right way to think of EGP isn't to consider it "ultra low margin publishing," but a form of collaborative R&D.

And just as it will be easier for EGP developers to work with Unreal, it should be easier for the *Fortnite* teams to work with these developers on related experiences, projects and "Limited Time Modes."

The first part of this series focused on Epic's Unreal Engine. The next part of this series will publish on May 20 and cover Epic Online Services. May 21st will cover Fortnite. May 22nd will then explain how everything Epic does fits into Sweeney's vision for the future, and how it's transforming the way its competitors, partners and consumers think, too.

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