Esports and the Dangers of Serving at the Pleasure of a King — MatthewBall.vc

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Under COVID-19, esports is having its moment. Numerous games, from NASCAR to *League of Legends*, have received their first-ever appearances on major US broadcast and cable television networks. Many of these same networks are airing live esports matches for the first time, such as the Fox broadcast network. Those with a history of esports programming, such as ESPN, are airing an unprecedented amount of esports content — in some cases, more than 14 hours per day. This coverage has meant that viewership for almost all esports titles are at record highs — in part due to the category's (perhaps reluctant) embrace by previously "IRL-only" sports fans. Similarly, many "real" athletes in the NBA, UEFA, and NASCAR have recently participated in and praised professional esports. This mix of new-found distribution, ratings, and support, in turn, has led to many blue-chip giants to begin advertising in professional gaming competitions after years of disinterest.

None of this is new, per se. Instead, it's an acceleration of long-running trends. Gaming, game broadcasting, and professional gaming have been growing in revenue, reach, and relevance for years. Furthermore, today's popularity is not immediately sustainable, either — nor is its growth rate. As COVID subsides, esports fervor will recede, ratings will drop, and revenues will reduce. However, the novel coronavirus will have permanently increased esports' overall economic and cultural trajectory. As a category, it has been popularized and legitimized in an unpredictable and profound way. And in 2020, 2021, 2022 and forever after, there will be more revenue, more funding, more viewership, and better distribution as a result.

This is obviously good for the ecosystem. But esports overall was in desperate need of such a shock, too. For all the excitement around esports since 2014, most teams are struggling — trapped in a vicious cycle of underperforming revenues, too-high valuations, and losses that make it impossible to invest in growth. Meanwhile, almost all of the start-ups built around the supposed esports ecosystem have floundered or shut down. A 2019 report by Kotaku found numerous esports executives that defined the industry as varyingly "unsustainable", "overhyped", and often "fraudulent". In 2017, Morgan Stanley estimated that in its debut season (2018), the US-only Overwatch League could gross $720MM in revenue (WWE generated $900MM that year). But in 2018, the global esports industry generated $775MM across all titles, with the US less than $200MM across all titles, according to Newzoo. Various teams suggest OWL generated between a one tenth and one eighth of Morgan Stanley's estimate. In 2017, Newzoo declared esports would generate between $1.5-2.5B in annual revenues by 2020 (this estimate became essentially inescapable). In 2020, Newzoo revised its forecast down to $1.1B - a quarter less than the initial low estimate and less than half of the high.

The industry has also been rife with convenient but not exactly false exaggeration. Traditional sports don't count a viewer until at least six minutes has been viewed, while vanity esports metrics typically focus on "total views". Furthermore, this number is boosted by the embedding of live streams into franchise and team pages, fansites, press pages, and so on. It also counts every browser refresh or device used by a single viewer as a different view.

Still, excessive expectations aren't sufficient to explain the struggles in the ecosystem. "If you looked into it, [the number of money-losing teams] is probably closer to 89 percent than 50 percent", one esports executive told Kotaku. That has nothing to do with valuations or, in a direct sense, money raised. A number of teams have shut down, sold their rights to individual leagues, or otherwise scaled down. This isn't necessarily bad. The industry is still finding its footing. But it also isn't how leagues with capped competition and guaranteed revenues are supposed to work. And overall, the operating environment for any esports-based company remains shaky at best and boasts few success stories and myriad failures. To understand why, it's helpful to start with what an "esports league" is. Most of the problems start from the fact that when you hear "esports league", you think in terms of physical "sports leagues".

Esports Leagues Are Not Electronic Versions of Sports Leagues

In traditional sports, there are basically two core league models.

The first is a "decentralized league", such as the PGA Tour, International Tennis Federation, or NASCAR. Under this model, there are a number of independently operated events that use a common rules system that is administered by a "regulatory" body (e.g. the PGA). In most cases, these events wrap together under a broader league table (i.e. points are ascribed to select events) and lead to culminating marquee events (e.g. the Masters), with participants chosen based on the league table or other related systems.

The second is a "centralized league", such as the NBA or MLB. Here, all matches and tournaments in a league are managed by a core body that defines everything from rules to schedules and compensation, and both collects the majority of revenues and sets/enforces guidelines on the rest. At the extreme, we see globally centralized leagues. In soccer/football, for example, FIFA doesn't oversee a single league (unlike the NBA), but it effectively oversees all leagues, conferences, and organizations in the sport. While member organizations manage day-to-day operations, FIFA owns all the rules and administrates inter-party decision making.

Yet even under the most globally controlled league models, the administrating body has far from total control over the sport. A spectator or fan can play soccer or golf without FIFA or the PGA, just as they can set up their own leagues and teams, or broadcast their private games and events.

Esports is different. While we see leagues across each of the aforementioned models, all competitive play is ultimately (and essentially end-to-end) dependent on the game's publisher. Most simply, independent leagues, events, and tournaments, whether for- or non-profit, do not have the right to operate (let alone broadcast to at-home audiences). They can only do so as allowed (explicitly or tacitly) by a publisher. All it takes is a publisher's copyright claim, cease-and-desist order, or policy change to shut them down. This is true even if the games are played online via location connections, too. And certainly, in the case of remote, online play, all gameplay is ultimately administered ("refereed", if you will) by the publisher's online services. This means the publishers are effectively co-running the tournament or league – even if they don't know it.

At a broader level, it's also important to emphasize that matches can only be played with the rules, options, gameplay, physics, items, and characters that the publisher offers. If your favorite "hero" is removed, you can't use them. If you loved a limited time event that's no longer offered, too bad. If a rule, item, or map changed, you've no choice but to adapt. Because you can't "run" *Call of Duty* without Activision Blizzard; you can only play the specific versions of *Call of Duty* they allow.

Publishers have control over their leagues in ways the sports industry has simply never seen before. Few analysts were bullish on the two non-NFL American football leagues (e.g. the new XFL and Alliance of American Football) that launched in 2017 and 2018, but they're at least legally and technically possible. And if Tom Brady wants to build a training academy for potential NFL draftees, he can do so without ever involving the NFL.

Risks Don't Need to Be Problems

This unprecedented control is a risk, but it's not *necessarily* a problem. Most publishers want as many of their games as possible to become successful esports. They prefer more viewers and more revenues to less; they hope their leagues get the best distribution deals with the biggest networks and at the highest fees. They want professional players to be happy, teams to make money, and the ecosystem to thrive by super-charging their IP. The problem stems from where conflicts of interests arise — or even just misaligned interests. These are common in esports and have a profoundly limiting effect.

A good way to think about the problem is by considering priorities. Adam Silver and Roger Goodell wake up every day and try to make money for the NBA and NFL team owners – their bosses. This is not how esports works. Those that "run" the official leagues (or otherwise allow for independent ones) are optimizing for the "sport" (e.g. basketball, football), not the "league" and certainly not the individual owners. The priority is *Overwatch*, not the Overwatch League. *Fortnite* (or, uh, the trillion-dollars-in-the-making Metaverse), not the Fortnite World Cup. Ultimately, this comes to a core point. For the publisher, esports is a marketing and engagement event for current and likely players.

Note, too, the delta between the "sport" and the "sports league" in terms of value, investment, total engagement (time and people) is enormous. The video games upon which each league is based generate billions of dollars in value in the sale of content, digital items, and subscriptions. The customers here are everyday players and there are millions of them. This monetization model and customer group is every publisher's core business. In comparison, esports drives tens of millions in low-margin revenue, based on a few dozen players and, at least today, tens of thousands of viewers (almost all of which are always players). The problem is teams depend almost exclusively on this latter and much smaller bucket of revenues and players

This is, again, a strong contrast. FIFA, MLB, PGA, and almost all other leagues don't make their money by selling "bats or balls" to everyday fans, nor by enabling the at-home audience to play the game themselves. Instead, they sell the entertainment of the league. Furthermore, the physical leagues are limited in the bats-or-balls game, too. A consumer need not buy an NBA-branded basketball to play basketball. And it's impossible to prevent fake jersey sales, too. Neither of these are true in video games — you can only buy from the league and use their equipment.

And when/where a physical sports league generates ancillary revenues from merchandise, apparel or sponsorships, all of this revenue tends to be shared with the leagues and the players. In the NBA, for example, the allocation of revenues is based on a term called "basketball-related income". It's intended to cover and share, well, everything related to the business of the NBA. The centralized esports leagues do have similar calculations that include distribution rights, merchandise, in-game items tied to esports events or using team iconography, etc. — but of course, they exclude the game and anything not directly attributable to the league. Furthermore, the leagues receive no fees or revenue for marketing the game, either.

In fact, the publishers themselves take up to 50% of revenue directly attributed to their esports leagues. This means that after buying a franchise fee from a publisher, the teams effectively (but not literally) pay a royalty back to the publisher. This is the reverse of the NBA example, in which the "league" collects revenues in order to allocate it to the teams. It isn't "the business", nor a profit-seeking one. It operates for the owners. In esports, the league body collects all revenues then keeps the largest share of it before allocating the residual to the teams.

In Activision Blizzard's leagues, the 50/50 revenue share occurs after the publisher recoups its own esports costs. Only then does the money go to the teams who hope to cover their own costs. Worse still, the teams have no control over this center-office spend. A league can decide to spend an extra $100MM on season marketing or other expenses, all of which will be immediately recouped out of league revenues at the expense of team revenue shares, at their sole discretion, and with their games/IP also benefiting from the added budget.

The decentralized leagues don't share any revenue, but they also can't produce any in-game events or virtual items, and nearly all other revenues (merchandise, broadcast, etc.) are limited by the fact they're in legal purgatory. And as the publishers launch their own "official leagues", they are undermining the perceived value of these third-party events, while also siphoning talent and constraining their operations (e.g. allowing for third-party tournaments, but only during the "official league" off-season).

The Consequences of Conflicting Priorities

These are real *challenges, but* they don't mean esports teams and other related businesses can't work. The problem is that while all parties share a desire for esports to "work", publisher priorities often conflict on a fundamental and day-to-day basis.

To return to the NBA, it's important to consider that NBA games aren't designed to be the most fun to play. They are designed to be compelling for viewers (hence rule changes for fourth quarter timeouts) and to maximize league revenues (hence the constant addition of new teams, longer seasons, spinoff tournaments, and events). Pickup basketball and H-O-R-S-E, meanwhile, are designed to be fun to play.

Counter-Strike, *League of Legends*, and *Overwatch* are not *designed* to be good viewer experiences. They're designed to be fun for players — the publisher's core customers — not a handful of professional ones or dozen league owners. This makes it difficult for any league to acquire fans that aren't also players, and for many players to fully appreciate (or even follow) professional play.

This is also why video games, unlike professional sports, are constantly changed. The goal is to keep the game fresh for millions of non-professional players. This, of course, often annoys and even harms professional players — all of whom are incredibly sensitive to even the smallest change in the damage done by a gun, the speed of a reload, or the layout of a map (not to mention outright removing established maps, guns or characters outright). Most leagues now try to accommodate this issue by withholding some changes from competitive play or phasing them in on different timeline. However, nothing is going to be maintained or held off indefinitely just for professional play. There are limits to forking a living game.

(To quote one VC, "Esports is as though Spalding owned the NBA, rather than the owners or players' association. And eventually, Spalding would announce the game has three balls.")

In other instances, the publishers make decisions that make sense for their businesses but cleanly conflict with the priorities and profitability of the teams. One team owner gave me the following example: "Most publishers would prefer, say a $75MM rights deal from Twitch than a $100MM deal from Mixer [Twitch is roughly 250x bigger in terms of streaming hours]. In fact, they'd probably prefer $50MM total for all three [including YouTube] to share non-exclusive rights as that maximizes total eyeballs". And while the teams, too, should prefer maximizing reach, few believe that platform choice will grow the number of esports fans. No would-be fan is ignoring professional *League of Legends* because it's on Twitch not YouTube. And crucially, this rights decision is at the sole discretion of the publisher, with teams informed after the fact. (A senior executive at a major gaming platform joked to me that teams are just esports sub-departments publishers decided to outsource - and then bill for the privilege of supplying services).

To put this in perspective, return to the NFL or MLB. Imagine that these leagues take a 50% discount on rights fees — their single largest revenue driver — because they prefer that Fox and NBC both air their games. Or that the owners might have no choice in the matter. Notably, half (or even all) of $25–50MM per year to a publisher is negligible. To teams, however, it's enormous. Especially when this money is first used by the publisher to "recoup". An incremental $25MM can mean the difference between not a dollar shared and millions.

Another example from a team owner was more cynical: "Publishers aren't excited about creating, let alone pushing, virtual goods that tie into their little-watched leagues and require paying us a royalty. They'd rather make unbranded items that appeal to all players, not just esports fans, and include no royalty. And if they're going to pay a royalty, they'd rather it be for, say, Marvel IP, not our team logo."

The publishers argue that such items also generate limited revenues anyway. And so even if the teams financed the development cost of such merchandise themselves, they're not worth the promotional inventory. Sure, a digital store can house unlimited items — but there's still finite promotional capacity. The publisher is probably right here, but this very dynamic speaks to the economic confines of leagues built to appeal only to a subset of gamers and which receive limited investment. At the same time, leagues also drive micro-transactions that aren't captured as part of "directly attributed revenue". Many professional players, for example, will popularize a given skin or character and, in so doing, lead players to buy them. However, they receive no bounty or royalty. This doesn't mean the value here is enormous — it's probably not. But it does help emphasize the imbalance of power and the fact that, again, esports is marketing.

One of the ways "teams" have sought to produce value is by operating across multiple leagues (i.e. games) under the same brand. The analogy here would be as though the Los Angeles Lakers (NBA) was also the name used for the LA Kings (NHL), LA Galaxy (MLS), LA Dodgers (MLB), and so on. And so, while any individual team might have modest profits, collective income could be substantial. In addition, this would make it easier to justify (i.e. monetize) further investment in a macro-level brand and produce numerous cost efficiencies (e.g. one hoodie rather than five). Many team owners also hoped that by amassing scale beyond any league, they would also amass greater leverage over the publishers. They would, in effect, "own" esports fans while the publishers would own game "fans".

However, most new major leagues no longer allow for such brand sharing. All new teams must use names specific to every league, even when under the same publisher umbrella (e.g. you can't use the same name even in Activision Blizzard's Overwatch League and Call of Duty leagues). This means the parent company must build several brand-new consumer brands concurrently.

The leagues have several fair arguments here. For example, if every team uses the brand of a parent organization, wouldn't a sale of an individual team mean scrapping the brand? That's obviously terrible for fans and the league overall. And what if Team A wants to sell its Team A–branded *League of Legends* team to Team B? That's even worse. In addition, some leagues have location-specific teams (e.g. London or Philadelphia). As a result, it's confusing if Team A uses the same brand for teams in different games based in different cities, or for teams that have no location at all. The preference for native brands is reasonable and clear, but it nevertheless presents an enormous financial burden in an already strained space. And most teams believe there are other ways to solve the above issues, with the true motive being a desire to keep "teams" from becoming too strong.

The biggest outlier here is Valve's approach to professional *Counter-Strike*. Notably, the title remains one of the most-played esports in the West and is typically its most watched, too — even though it has barely been updated and boasts aged graphics. This may not be a coincidence. Rather than own/operate/invest in a proprietary league like most publishers, Valve chooses to support and encourage a host of third-party tournaments, organizations, and leagues. It also keeps the game stable (rather than make frequent updates) and works well with third-party analytics/data/extensions providers to enhance the experience. At the same time, Valve isn't really a publisher — it's a platform. It's the world's largest digital seller of third-party games, one of the largest online player networks, and one with recurring hardware ambitions. Founder Gabe Newell, who is also a strong believer in open-source systems, is also clear that Valve only makes games as a means to fund/accelerate technology (hence no Half-Life 3). Platform and IP companies are very different, and thus so too are policies on outside partnerships and networks.

What's more, even Valve's partner-centric approach leads to conflicts. While Valve happily allows for professional tournaments to charge distribution partners (e.g. YouTube) or customers for access to their production, Valve requires all gameplay to be freely viewable inside Steam so that other parties can participate and benefit too. This would be as though ESPN could air its official coverage of the NBA finals (inclusive on commentary, bespoke graphics, half-time panels), but audiences could also go to NBA.com and watch the game without any ESPN editorial – and could, in fact, even watch it with another party's commentary and proprietary analytics. The ESPN edition should be the best, as it would benefit from exclusive access to the players and involvement in the literal production of the event. However, it will nevertheless lose parts of its potential viewers. In addition, third parties would be able to monetize much of ESPN's own event production investment and video content – with no royalty paid!

Over/Under/Everywhere

Ultimately, the teams are just a small part of the esports story. There are hundreds of start-ups that have collectively raised hundreds of millions of dollars to pursue affiliated experiences such as esports betting, esports fantasy, esports data/analytics, esports training/coaching, esports highlights, and so forth.

These companies (like the teams) are trying to build "platforms" around esports IP, where the customer of the publisher (a professional or non-professional player) is also the start-up's customer. The challenge here is that esports IP is not (presently) an app store or third-party ecosystem like iOS (certainly there are no comparable long-term commitments around APIs, third-party support, etc.). And at the end of the day it's very difficult to create enterprise value in an ecosystem where a single party — which is also a highly successful, scaled and for-profit company — controls all the value levers and sees your business (esports) as a marketing event rather than a profit generator.

Does Overwatch League, for example, care about third-party stats/analytics companies? Maybe. Does it care if they make money? No. But if one day the league decides to pull its APIs, change its Terms of Service, or sees enough value to build its own stats/analytics services, these companies are dead.

And that's what we've seen. For example, Pursuit and Visor each sought to build real-time and post-game analytics tools for *Overwatch* players back in 2017 and 2018, raising at least $10MM. Eventually, Activision Blizzard pulled the APIs and banned the companies, while also threatening to suspend players that continued to use them. Esports One, meanwhile, tried to build such a service for *League of Legends*. It still exists, but it relaunched as a fantasy esports company.

(The sustainable ecosystem play here is probably selling technologies to publishers, not players — especially when these technologies don't also try to own the customer. Unity, Unreal and Genvid (a portfolio company), for example, are used to power major esports/gaming titles but focus on enabling the publisher to generate value both in the sports and beyond it.)

And if publishers' mentalities shift toward considering esports as a revenue generator, they are likely to further expand their control of esports activities, not relinquish them. They may still allow for third-party services — or even enable more of them — but it's likely that in that case they'll begin charging large fees for their API feeds. Twitch only survived because it scaled early and convinced Riot Games not to shut down League of Legends broadcasts. But most other companies around the ecosystem can't generate that kind of enterprise value — and the publishers have learned their lesson.

Consider, for example, that Riot has announced that to launch and accelerate *Valorant*, it will rely on, support, and officially endorse third parties ("Our primary focus early on will be forming partnerships with players, content creators, tournament organizers and developers — unlocking them to help us to build the Valorant ecosystem.") This is a smart strategy and similar to how every esports began, including *League of Legends* and *Overwatch*. At the same time, Riot admits it is looking into setting up its own league — just as it did with *League of Legends*.

To this end, we have already seen this story play out. Not long after Riot began to fully professionalize its LCS league and sell permanent franchise rights, the company announced its teams would no longer participate in (let alone incorporate) tournaments and leagues operated by ESL. The rationale here was fair: schedules conflicted, players needed time to rest, and Riot was building up its own tournaments. Riot, as the IP owner, had the right for such a policy shift. However, it left ESL, which had operated the IEM since 2011, helped popularize *League of Legends* outside of China, and become the largest independent esports tournament organizer and production company globally, with no future in the sport. It stopped producing *League of Legends* events the next year.

So How Do You Produce Value in Esports?

To return to the teams, it's clear that several multi-sport brands have produced real value. However, there are some interesting thought experiments here. For example, we've never had a major sport emerge in the digital era — a time in which a fan can just as easily watch a team based in their city as they can one 12,451 miles away. And to this end, many of the world's biggest traditional teams — Real Madrid, LA Lakers, New Zealand Allblacks — have all grown their fandoms as they've transcended their local, national, and regional limitations. This is the world in which today's esports teams are launching, and it's not clear audiences will want to support a local team over the bigger, better, cooler one that's based elsewhere. If you're a fan investing now, why support the new St. Louis team rather than the best one based wherever else (be it NYC or Paris or Sierra Leone)? And in several leagues, no team has a defined city at all. Why/how will every team get a fan?

These dynamics might explain why several brands, such as Cloud9 and Team Liquid, have thrived while most languish. It's not clear that there's a solution here. And ultimately, every league depends on many teams succeeding, not just one or two. And all need to succeed over the long run.

In addition, several of the most valuable "teams", such as 100 Thieves or Faze Clan, aren't really esports companies. Their teams are important, but they're only a part of their parents' organizations — and usually on the smaller side. In truth, most of the revenue and profit comes from media revenues (i.e. personality-based Twitch livestreaming and YouTube videos) and lifestyle merchandise. In other words, if esports is game marketing for publishers, esports is marketing for 100 Thieves. But again, there's probably not room for too many brands.

Also consider importance of generation and time. Even the NBA, the youngest and most future-forward league, leans heavily on nostalgia. The new generation of American soccer teams borrow heavily from early 20th century football, from the club-based naming conventions (e.g. Toronto FC or the absurdly named Real Salt Lake), to its culture (scarves and TIFOs). Sports and teams are about continuity — and that requires stability. Video games are in a process of constant change. And overall, the NBA cares that basketball is a sport of the future. Activision Blizzard cares that irrespective of which esports are played in the future, they own as many of them as possible.

There are still several bull cases. The secular tailwinds behind gaming will continue, raising the overall value of sports and esports alike. The leagues will also continue to evolve and mature. Ultimately, league and team failures benefit no one, and all parties hope for greater revenues, greater audiences, greater distribution, and so on. The major owners have been largely unsuccessful in lobbying leagues for change so far, but prolonged duress will inevitably lead to change. In addition, Collective Bargaining Agreements, though resisted to date, do feel inevitable over a long enough time horizon. To this end, leagues take time to get it right. The NBA is great now, but it took decades of learning, policy changes, and mistakes.

And as video game makers continue their transformation into proper media companies (leagues are live events businesses, most publishers are launching Hollywood studios, etc.), they may also come to see esports as a profit area, rather than just a marketing exposure. To this end, games are increasingly being designed to be fun to play, fun to watch, and fun for professionals. *Overwatch* was one attempt at this triple goal — though it hasn't quite worked — but all of the publishers are trying (See Riot and *Valorant*), the strategy is still new, and there's lots of iteration/learning left. One day, there might be a game with the popularity of *Fortnite*, the longevity of *League of Legends*, and incentives closer to the NBA. In addition, more opportunities will emerge for teams to leverage their brands and followings into new revenue streams (recently, 100 Thieves released its esports apparel as virtual items in *Animal Crossing*, an incredibly un-esports game).

None of this means that esports teams will become enormously profitable, let alone many of them. When you serve at the leisure of the king, you can only get so rich.

Finally, it's important to temper expectations around COVID-related lift to esports, especially whether the rising tide will be evenly distributed. NASCAR iRacing, for example, is virtually indistinguishable from the real thing, easy to understand, and doesn't require a NASCAR fan to "learn" how the sport works. NBA 2K isn't as real looking, but can be seamlessly followed by a fan of the IRL sport and still allows these fans to see and root for their heroes. This is in strong contrast to the major esports. *Counter-Strike* and *Call of Duty* are relatively simple, but they still require education and are clearly synthetic. *League of Legends* is enormously difficult to follow, fantastical, and obviously not real.

In addition, we have to return to the idea of "design". Physical sports like NASCAR and the NBA were made to be fun to watch. The fact they're now virtually rendered doesn't change this construction. But to this end, their success as digital simulation doesn't mean that the video games designed around play, not viewership, will suddenly work as viewed sport.

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