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THE GAME TURNS SERIOUS AT ATARI

BYLINE: By ANDREW POLLACK**SECTION:** Section 3; Page 1, Column 2; Financial Desk**LENGTH:** 2390 words

WORKING at Atari Inc. is like playing one of the company's video games. It requires quick reflexes, and one's turn at the controls maybe short-lived. Just in the last two weeks three Atari executives - none of whom had been at the company for more than eight months - have been zapped.

Such rapid-fire dismissals, as well as resignations, have become a trademark of the world's largest video game producer and of its mercurial chairman and chief executive officer, Raymond E. Kassar. The high turnover was saying something about the management of Atari, but few people were listening. After all, Atari was probably the fastest growing company in the nation, climbing to about \$2 billion in sales in a few years as the video game craze swept America.

Now people are taking notice. In the last two weeks, a series of revelations have rocked the video game industry. The most stunning was the sudden announcement 11 days ago that Atari's parent, Warner Communications Inc., expected a dramatic slump in fourth quarter per-share earnings - the first such decline in 31 quarters - largely because of disappointing sales of Atari's video game cartridges. The news sent the stock of Warner and other game-related companies reeling and has provoked a major reassessment of a company that has captured as much attention on Wall Street as it has in arcades and family living rooms.

"Why did it happen so quickly? And why were they not in tune with it while it was building?" said Richard P. Simon, an analyst with Goldman, Sachs & Company, referring to the unexpectedly low cartridge sales. "I think one has to clearly question their controls in light of this." Added Michele Preston, an analyst at Cyrus J. Lawrence: "I'm not satisfied with the explanation. And there are some real fundamental questions posed for the long term."

The situation at Atari is by no means dire. The video game industry in general and Atari in particular are still growing, although profit margins are shriveling from intense competition. And Warner still expects to report a 10 to 15 percent increase for all of 1982, an improvement that would delight many other companies during a recession.

THE gain, however, is just not what people had come to expect from Warner and from Atari, which in the first nine months of 1982 contributed half of Warner's \$2.9 billion in revenues and two thirds of its \$471 million in operating profits.

Warner's earnings statement said the company expects fourth quarter profits to be roughly 60 cents a share, only half the level of the \$1.17 a share recorded in last year's fourth quarter. Even more dramatic, the results will be only a third of the \$1.60 to \$2.00 expected by virtually all Wall Street analysts, who, now furious and embarrassed, say that the company privately confirmed such estimates up to the morning before the Dec. 8 bombshell announcement. Warner's stock slid more than 16 points the following day and has continued to fall, closing Friday at 30 3/4, down from 53 5/8 on Dec. 7. And shareholders have filed suits accusing the company of withholding important information about its

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finances.

Atari is also facing problems in its two other businesses. Its arcade game business has dropped into the red this quarter and its home computer business, which has never yet been profitable, faces a market-share battle.

But perhaps even more important than problems with specific businesses is the question of whether Atari's management is ready for a period in which growth and profits will not come as easily.

One management problem Atari concedes it has is that its fixed costs have gotten out of line. At a meeting with securities analysts Monday, Emanuel Gerard, co-chief operating officer of Warner, said the company would take a hard look at its overhead now that sales are less than expected.

Another problem is rapid turnover. A 25-year veteran of Burlington Industries, Mr. Kassar, 54 years old, has been trying to change Atari from a loosely organized band of engineers into a serious, businesslike, market-oriented company. He recruited executives, like himself, with marketing experience but no electronics experience, from companies such as Polaroid, Jovan and American Can. But just as quickly as he lures them, Mr. Kassar seems to lose them.

On the same day Warner announced lower earnings it announced that Perry D. Odak, the president of Atari's home video game division, had been discharged, after being on the job six months. The company and Mr. Odak insist the dismissal was the result of a difference in management style between Mr. Odak and Mr. Kassar and was not related to the shortfall in cartridge sales. Also dismissed in the last two weeks were Thomas M. McDonough, senior vice president of sales and marketing in Atari's home computer division, who had been on the job eight months, and Lee Henderson, vice president of field sales for the home video game division, who had been on the job two months.

The presidents of Atari's two other divisions, home computers and arcade games, left the company last summer, and there have been numerous other dismissals and resignations in the last few years.

Mr. Gerard said the turnover is an inevitable result of rapid growth. Atari has grown from less than \$200 million in revenues in 1978, just before Mr. Kassar took over, to roughly ten times that in 1982. Its staff has mushroomed to 10,000 people, with 4,000 added in this year alone. They are spread among more than 50 buildings in California's Silicon Valley, south of San Francisco.

"The stresses and strains that are created by that kind of growth are phenomenal," said Mr. Gerard, explaining that the situation was made worse by the fact that Atari, now 10 years old, had no corporate tradition. "You can't deal with the company as if it were General Electric, because it ain't," he said.

Others, however, say the turnover is a function of Mr. Kassar's style. "You can't build a stable organization without solid people," said Robert A. Hovee, a former vice president of sales and marketing for the home computer division. Yet, he said, Mr. Kassar does not delegate enough responsibility, making it hard to keep the strong-minded people he recruits. Other former managers describe Mr. Kassar as someone who changes his mind frequently both on company direction and on which subordinates are in his favor.

The recent slump in earnings comes at a time when the overall video game business is good. Sales for the entire industry are expected to double in 1982, to \$2 billion, with the total about evenly split between the machines on which the games are played - the hardware - and the game cartridges, or software.

But, like with razors and razor blades, cartridges are more profitable than the machines. The cartridges cost a few dollars to make and can sell for more than \$20 at retail. According to estimates by Mr. Simon of Goldman Sachs, cartridge sales accounted for \$180 million of Atari's \$280 million in operating profits in 1981. When cartridge sales fell short of expectations, the results went straight to the bottom line.

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It began back in October, 1981, when Atari met with its distributors and asked them to commit to orders for virtually all of 1982. At that time, Atari had about 80 percent of the hardware and software market, with Mattel its main competitor. In previous years, Atari had been unable to deliver all that was desired, so distributors ordered more than they really thought they would need.

But come the middle of this year, the situation had changed dramatically. Numerous companies were in the software business including Coleco Industries, Activision, Imagic and Parker Brothers. "We got into the last half of this year and we were in a totally different business," said Barry Furman, chairman of R&S Distributing Company, an Atari distributor in the Philadelphia area.

Order cancellations began pouring in, and Atari's market share slipped precipitously. Analysts wonder why Atari didn't realize until December how serious the cancellations were.

"We were just dumb," Mr. Gerard said in an interview, saying the company was "blind-sided" because it had never experienced competition and massive order cancellations before. He said the company is changing its procedures to prevent that from happening again.

Atari was also hurt because it had a weak lineup of games going into the second half. It was depending on games licensed from the movies "E.T." and "Raiders of the Lost Ark," games that have not been the blockbusters Atari expected. In the first quarter of next year, Atari will introduce five games that are derived from popular arcade games. Such games might restore its market share and could have made a difference if the company had them before Christmas.

Mr. Gerard told analysts that the company was "lulled" by its previous success. In particular, its home video version of Pac-Man, though widely faulted for the quality of its graphic display, still sold extremely well. It came out just before the competition hit and made Atari think it could sell virtually anything. It couldn't.

The events have implications for the entire industry. While Mr. Gerard said overall industry cartridge sales are likely to increase again next year, only popular games from now on will bring profits. Each new game will have to be promoted like a motion picture, entailing high advertising expenses. Indeed, Mattel said that despite increasing hardware and software sales, it expects to lose money in its current quarter, partly because of high promotional expenses. Also, earnings of video game companies in the future will fluctuate like those of movie companies, depending on whether the company has hits or not.

The events also raise a question about whether Atari has lost too much of its entrepreneurial spirit and creativity. The company was founded in 1972 by Nolan Bushnell, whose first successful game was a coin-operated Ping-Pong game called Pong. The name Atari came from a term in the Japanese game of Go.

At first the company was run by engineers in tee-shirts. Noah L. Anglin, a former vice president of manufacturing and engineering, recalled that at his job interview, Atari executives were worried because he had spent 13 years at I.B.M. Usually, experience at I.B.M. is considered an asset.

But Atari had trouble financing its own growth and began looking for a suitor. Warner purchased Atari for a mere \$28 million in 1976, mainly at the urging of Mr. Gerard. "That has to be the greatest acquisition in history," said Donald Valentine, a California venture capitalist who was an initial backer of Atari. Mr. Gerard ousted Mr. Bushnell and his associates and installed Mr. Kassar.

As the company has grown, it has shifted to being market-driven rather than entrepreneurial and engineering-driven. The company is using its considerable financial muscle to license arcade games from others - mainly Japanese companies. Some of the games most responsible for Atari's success, such as Space Invaders and Pac-Man, were created by others.

But some, like Mr. Anglin, think Atari has become too dependent on others and has been slack in designing its own

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games. Some of Atari's top game designers, partly because they did not feel appreciated at Atari, have left for competitors such as Activision, which offered them stakes in the company or other incentives.

As the competition arose, Atari has also resorted to legal action. At one time or another it has sued Activision, Imagic, Coleco, Commodore and Magnavox, charging patent infringement or unfair trade practices.

"They're seeking to win victory in court that they can no longer win in the market," said Arnold C. Greenberg, president and chief executive of Coleco. When Atari sued Coleco for patent infringement earlier this month, Coleco responded by filing an antitrust countersuit,

A problem getting its own games to market also has hurt the coinoperated game business. "The fourth quarter of 1981 was, by a considerable margin, the best quarter in the history of the coin-op division," Mr. Gerard told analysts. "The first quarter of 1982 was very good. The second quarter was a good quarter. The third quarter was a rotten quarter and the fourth quarter is a disaster."

The arcade game industry as a whole is suffering from a glut of machines and few new places to put them. But Atari is suffering in particular because of a lack of hit games. "We went dry somewhere in the spring," Mr. Gerard said.

Recently Atari introduced Pole Position - yet another Japanese game. Mr. Gerard said that game, and some others, are already turning the coin-op division around.

Atari's future may lie with its home computer division. The market for home - as opposed to small-business computers - has taken off this year and Atari has seen its sales quadruple, to an estimated \$300 million. Yet the division is still losing money, perhaps \$25 million \$50 million this year.

Atari was the first company to clearly aim for the home market with a computer selling for only a few hundred dollars, as opposed to machines like the Apple that sell for more than \$1,000. But recently companies like Texas Instruments and Commodore International have come on strong, and a price and market-share war has developed.

Atari has many strong suits. It has a joint venture with Lucasfilm Ltd., the producer of Star Wars, to design innovative new games. It has a tremendous advertising budget, estimated at more than \$100 million this year, and a prodigious research and development budget of almost the same size. It has hired Alan Kay, a highly regarded computer scientist, as its chief scientist and told him to "dream" up new products.

One new product is the mysterious "Falcon" project. Atari has said that next year it will introduce a new consumer electronics product, not a game, that will be the basis for a fourth division in the company.

Speculation centers on a communications device, perhaps a telephone with computerized functions or a device to be used with cable television systems. But analysts wonder why Atari is alerting everyone to the product's existence if it is really so marvelous. In the new atmosphere of lost innocence and heightened skepticism surrounding Atari, many would rather just wait and see.

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GRAPHIC: Illustrations: photo of Kassir p.8. graph of Atari profits

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