

The Complex Terrain of the Video Game Industry: Challenges and Opportunities

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The video game industry is brimming with innovation, competition, and transformative technological advancements. As we look at the current state of this vibrant sector, it is evident there are both challenges and opportunities, particularly for venture capital investors. Lyman Thai, a San Francisco and Silicon Valley-based partner in the firm's Transactions Practice Group and Venture & Growth Capital Team, is a keen observer of the video gaming industry and has extensive experience representing game studios, gaming-adjacent technology companies, and their investors. He sheds light on the intricate legal considerations and strategic maneuvers necessary for success in this ever-evolving sector.

An Overview of the Current State of the Video Game Industry

According to Lyman, the video game industry is now characterized by increasing competition for attention, exciting technological advancements, labor upheavals, high volatility, and significant capital needs.

He points to a stagnation of post-pandemic revenue growth in the video game industry as people have turned back to movies, TV, books, music, and other forms of in-person and live entertainment. Highly acclaimed game releases in 2023 have also been counterbalanced by high-profile cancellations and record-high layoffs in the video game industry in 2023 and into 2024.

On the technology side, Lyman says the growing use of generative AI in software development and the creation of gaming assets is changing studios' cost structures and labor demands. That's not to say that AI is necessarily reducing budgets; instead, costs will shift toward paying for AI computing resources and increased competition for top AI talent. Creative talent will still be in high demand to hone stories and humanize and make generative AI outputs their own.

He points to generative AI as a technology that will allow larger game studios to become even more ambitious for the same large budgets, while potentially reducing barriers to entry for smaller studios and indie game developers, "potentially" because smaller shops will still need to pay for the computing resources and talent. Among smaller game developers, this will increase competition for capital in an already highly volatile market where predicting the next hit franchise is far from certain.

Due to the hits-based nature of the business, investment in video gaming needs to happen at scale. Andreessen Horowitz recently raised a second \$600 million fund dedicated to the intersection of gaming and technology, part of which will go toward writing \$750,000 checks to up to 40 companies per cohort in their Speedrun early-stage gaming startup accelerator. While many of the companies in the accelerator are gaming-adjacent technology companies (e.g., AI, infrastructure), a large number of them are categorized as gaming studios. In gaming content, especially, even more so than in venture at large, an investor needs to be able to spread many bets in hopes that one will be the winning ticket. Speedrun game studio participants will get a valuable head-start on the competition, but success remains far from certain.

What are the Unique Challenges for Venture Capital Investors Looking at the Gaming Sector?

Lyman notes the first challenge facing investors is that investing in pure-play gaming content is a hits-driven business in which it is notoriously hard to predict winners. This needs to be reflected in the number of investments that an investor must make for a potential payout, the size of investments, and valuations.

The transformative impact of generative AI on game development also brings challenges, notably unresolved legal questions around intellectual property rights. For instance, using copyrighted content to train AI models has created novel copyright issues that are winding their way through the courts. There is a higher risk of third-party infringement claims, moreover, when generative AI outputs look strikingly similar to existing works used to train the AI model.

Additionally, Lyman says investors must be particularly attuned to the impact and enforcement of labor laws when navigating the video game industry. Unique aspects of the industry include the chiefly project-based nature of game studio work, the practice of furloughs or layoffs when priorities shift, unionization efforts and recent pushes to improve working conditions in the industry, and the previously mentioned change in labor structures and costs due to new technologies like generative AI.

Finally, he says a fragmented regulatory environment, especially for companies operating internationally, also poses potential legal challenges. Frequently evolving privacy and data regulations, even across states in the United States, will affect how data about player behavior is used or monetized. Game mechanics, such as micro-transactions/in-app purchases, pay-to-win, daily log-in rewards, and loot boxes, are increasingly the target of country-by-country legal scrutiny due to concerns about gambling, addiction and unfair and deceptive practices. Emerging regulations for artificial intelligence are already fragmented internationally across the US, EU, and China. Investors in cross-border deals also must watch out for a patchwork of sanctions and foreign investment restrictions driven by national security concerns.

Seizing Opportunities Amidst Complexity

Despite challenges, Lyman sees a wealth of opportunities within the video game industry for savvy investors.

He says that when investing in gaming-adjacent technology, an investor needs to use their imagination, and the company needs to be willing to see and develop potential applications of the technology beyond the video gaming industry. Gaming has long been at the forefront of adopting and

mainstreaming novel technologies, which is why the space is so exciting to invest in. NVIDIA, which started out making dedicated graphics processors for video games and has ridden the wave of AI computing to sit among the top three largest companies in the world by market capitalization, is only the latest example.

Looking ahead, the gaming sector continues to present a promising opportunity for investors. The industry's inherent creativity, resilience and potential for reinvention in uncertain times make it fertile ground to cultivate and grow world-changing technologies.

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