Kellogg School of Management

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Target Corporation:
Maintaining Relevance in the 21st Century Gaming Market

Steve Eastman liked to hunt pheasants. Pheasants, unlike deer, don't come to you, he often said—you have to go find them. To Eastman, president of Target Corporation's online sales division, the real benefit of hiking across frozen terrain in search of game was that it got your blood flowing and your mind relaxed. Life was better for being active outdoors. Your perspective and creativity were renewed.

This year for the first time, Eastman had asked three colleagues to join him for a weekend of outdoors activity to jumpstart their creativity as well as his. When they got back to the office Monday they'd be tackling what Eastman saw as the thorniest problem Target.com had come up against yet in its ten fast-moving years.

Video games were among the most productive categories in the parent corporation's chain of 1,744 Target Stores and SuperStores. In fact, the sales productivity and profit contribution of the video games category made it perhaps the highest performing area in the stores.

But unlike familiar Target staples such as coffee pots, car seats, or children's clothing, many entertainment products (primarily music, movies, books, and video games) could be digitally distributed. That is, they could be shopped for, bought, received, and installed all on a home laptop, personal cell phone, or gaming console like Microsoft's Xbox 360, Sony's PS3, or Nintendo's Wii. This was happening already to some degree. Because Target was still first and foremost a brick-and-mortar business, there was growing fear that the company's video games business would shrink, or even disappear, if something wasn't done to protect it.

Pausing to look beyond the corn stubble out toward the horizon, Eastman asked one of his three mud-spattered companions, "So, what are we going to do about games, Nik?"

Nik Nayar, Target's merchandising manager for consumer electronics products, was exceptionally bright and usually at no loss for words. But at this moment, he slowed down and chose his words deliberately. "We don't know what's going to happen three to five years out. We have seen in the music business what we hope will *not* happen.

"We've done quite a bit in our stores this last year to make them more welcoming to our core consumer segments," Nayar went on. "Among other changes, we've lowered the heights of display gondolas for better lines of sight, we've widened aisles for a less constrictive feel, we've warmed up the lighting and raised illumination so that it's easier to read the fine print on the back of a game package. And we've brought game boxes out from the glass cases, so that shoppers can handle them. The tactile experience remains a deep-seated road to acceptance and purchase. And yet, I feel we've still only scratched the surface."

"Let's remember," noted Steve Orzel, Target.com's group manager for electronics and entertainment, "at Target, we're only talking about one category out of many. While the margins on games software are very attractive, the profit on video game consoles is much smaller and the overall category has been running at less than 3 percent of our corporate total.

"All the same," he continued, "it's dismaying to see any profitable category migrate away from our traditional retail model toward digital storefronts. That phenomenon *is* starting to happen. Apple and Amazon have redefined how consumers obtain popular entertainment products. Worse, they're leaving the likes of us out of the new picture!"

"True," replied Mike Heller, a manager of category marketing who had recently led a major strategic review of Target's video games category. "But a powerful specialty retail competitor like Best Buy has far more at stake than we do. So does OnLive, for that matter. Do you know about them yet? OnLive is the Internet-only games retailer that launched a few weeks ago and has been getting lots of buzz among gamers. Walmart's recent online price cuts on best-selling books and DVDs directs its overwhelming buying power right at categories where online and specialty retailers can't afford to surrender all their margin."

"Hmm," Nayar responded. "Price wars are no solution, long term. Even Walmart can't hold the category without adding positive value to its mix. And simply putting up an online catalog of SKUs isn't the answer anymore, either. Digital distribution is becoming too tightly coordinated. Have you noticed how hardware and software services are starting to integrate vertically? That's bound to continue. How does Target participate effectively in that?"

"Well, a big part of the answer should come out of our drive to exploit synergy possibilities latent in Target's portfolio of stores and online formats," Eastman reminded them. "After all, our stores are far and away Target's biggest asset. We must harness the power in reaching cross-channel consumers, those guests that approach Target through the Internet *and* through the stores. I'm no 'digital native,' but my teenage daughter is. When I see how she mixes and matches the services and functionalities she can get online and offline, I start to imagine where we need to be headed. For me and my generation, digital shopping is a choice. For hers, it's simply the way things are, part of the mix. We need to future-proof Target's total portfolio of channel formats for next-generation consumers like her."

Heller added, "Let's agree that no matter how we play online and offline, we will be true to the distinctive way Target has always served our core guests. Target's success is built on serving families and women, especially moms. Target doesn't beat Walmart on price or Amazon on assortment. We differentiate on customer experience. Somehow we've got to anticipate the future of video games without contradicting our core brand equity with these valued guests."

"These are all good starting points," Eastman responded. "But fundamentally it's an investment issue. We can't afford to do everything offline or online. We have to decide where Target Corporation can get the best return on its capital.

"The way I see it, we have three options. I call them: traditional brick-and-mortar, contemporary digital, and next-generation hybrid.

"In the first option, we double-down on Target's store-based strengths and get the most share we can out of the games category. After all, in the U.S. market, retail stores still account for well over 90 percent of product sales across consumer industries. Who knows, maybe some digital product shopping is more amenable to tangible stores than it looks these days. Maybe our stores *can* grow games sales even as the industry evolves.

"In the second option, we go in the opposite direction. We aggressively reinforce Target.com as our target gamers' go-to destination (see **Exhibit 1**). That would probably mean we migrate sales out of our physical stores and maybe even cannibalize their business in the process. With online sales steadily moving up in North America to about 7 percent of total retail in the last year alone, we'd do pretty well just riding attractive segments of the digital growth curve.

"As for the third option, I have no idea what that looks like. But I'd imagine it as a fundamentally new response to consumers' growing interest in combining online and offline shopping relationships in new experiential ways. That might include mobile formats, hardware formats, stores formats, Internet formats, and who knows what else all working together in ways we haven't imagined yet. Whichever way we elect to go, we just need to be sure we make a solid case for it—one I can feel good about taking to the board."

For the remainder of the weekend, Eastman's three managers used free moments to bring him up to speed on their latest research into the video gaming business. By the time they picked up stakes, the Target.com president knew how he wanted his group thinking about these critical issues when they reassembled with other company leaders at an upcoming strategic offsite meeting. High on the agenda would be deciding Target's next steps to maintain relevance as the video game market evolved.

Target Corporation

Target's roots went back to 1902, when the Dayton Dry Goods Company opened in Minneapolis, Minnesota, one of a handful of America's original department stores. Even then, it was a store with a difference. Founder George Dayton's personal belief in "the higher ground of stewardship" put an emphasis on a generous spirit of giving, fair business practices, and dependable merchandise (it answered a railroad strike in 1920 by airlifting 400 pounds of product to Minneapolis, a commercial first). Dayton's heirs took the company regional at mid-century, then national. In 1962 Dayton opened the first Target store as an experiment in mass-market discount retailing.

Over time the company added the fashion flair, product quality, and high-service orientation of Dayton's department stores to the mass merchant's budget consciousness, creating a distinctive operation that carried forward George Dayton's vision into contemporary terms: *Expect More. Pay Less.*

By the 1990s the discounter's sales overshadowed the department store's, and in 2000 the company changed its name to Target. As mass merchandising came to dominate the American retail scene, Target Corporation grew to become one of the five biggest retailers in the United States. With 2008 revenues of $65 billion (see **Exhibit 2**), it ran in the same tight pack as Kroger, the biggest pure grocer; Costco, the biggest members-only retailer and wholesaler; and Home Depot, the biggest home center in the United States. All of them, however, trailed far behind Walmart, which had annual sales of $406 billion.

Target was originally more like Walmart than any other retailer, and therefore had historically the most to fear. In the 1990s, it looked as though Walmart's widening lead in market power could spell a survival crisis for a format as similar as Target's. Walmart had already all but marginalized Target's longtime budget-market peer K-Mart (formerly Kresge), and the battering it gave Sears Roebuck had left that former champion of broad-line merchandising gasping on the mat.

Target, on the other hand, not only survived—it prospered. Where Walmart muscled suppliers so that it could steadily lower prices and loudly proclaim to consumers (and competitors) that lowest price for a given quality meant highest value, Target succeeded by refusing to play the hyper-discount game. Although it went out of its way to sharpen price competitiveness on most of its products, Target did not try to out-discount Walmart. Indeed, in selected areas it went the other direction. It offered a superior mix of premium and discount items, maintaining premium-product prices in key categories where beefing up customer services and activities (and therefore costs) was essential to providing Target's core segments with differentiated value.

The strategy triumphed. To many suburban moms and their high-spending teenagers, Target was no longer comparable to Walmart. It was "Targé," with its echo of Fabergé and a more stylish life than discounters had heretofore represented. Loyal "guests" came to trust Target for themselves and their families. They liked the total experience. In fact, they liked themselves when shopping there. Target found that familiarity did not breed contempt—it bred lucrative repeat business.

Like Walmart and other mass-merchant retailers, Target carried a broad array of products and categories in order to offer its customers a convenient, one-stop shopping opportunity. Curation was how Target had long referred to its management of the concrete product, category, and brand options and the overall experience core customers would be given in the stores.

Not only did curation entail selecting a few products from among hundreds of competing supplier options, it also involved how products were grouped, located, displayed, priced, and communicated over time. Curation pulled together a view of every category along all these dimensions so that consumers would receive a reasonably consistent, valuable, and highly differentiated "Target" experience.

Within the overall mix of Target products, the video games category was a particularly high-performing one, with excellent levels of sales and contribution, both in absolute terms and—as retailers were prone to measure it—on a linear footage basis (see **Exhibit 3**).

The video games category also attracted customers whose profile dovetailed with Target's core focus: women shopping with children. In fact, recent data suggested that the women specifically shopping for video games at Target tended to be slightly younger with higher incomes, and were even more likely to be shopping with their kids.

But the category was not without its challenges. Market intelligence data was gathered to compare Target's success at converting video game browsers into buyers with that of competing video game retailers. The results were disappointing: Target converted only about 85 percent of the video game browsers converted by Walmart and Best Buy, and a mere 66 percent of the number converted by specialty retailer GameStop.

Opportunity for further improvement was being carefully evaluated, as every point of market share in video games translated into $200–$300 million in incremental Target revenue.

Digital Retailing

The history of retailing was largely a history of format changes. Stores that worked under one set of conditions were replaced by new formats better suited to the next era's conditions. Target and other mass merchants typified only one of a long history of dominant retailer formats, following centuries of evolution from market bazaars to local shops to department stores to specialty superstores, each format exhibiting multiple variations.

With the arrival of computers, the Internet, and telecommunications, this retailing evolution had ventured into cyberspace. This was a major step forward in the eyes of many experts, who predicted that retailers would become vastly more efficient, product and service selection would become broader, and consumers' buying power would be enhanced (see **Exhibits 4** through **6**).

Target had pushed far into digital retailing by 2010, as had its mass-merchant peers. Target.com, for instance, had become by 2009 the most downloaded retail app on the Apple iPhone. Target had worked the digital domain from the opposite direction, too. By being the first retailer to offer prepaid iTunes debit cards with individualized serial numbers, Target was able to participate in sales generated inside Apple's "walled garden," its proprietary digital iTunes store.

But these were small successes compared to the multiplier effect that retailer Web sites were having on corporate income statements. The sales impact of a Target.com, a Walmart.com, or a BestBuy.com far exceeded the size of its business unit's profit and loss statement (P&L). One statistic, solidly confirmed by industry research connecting visitor views with later store purchases, spoke volumes: for every $1 in sales transacted at a national retailer's Web site, those same shoppers would spend $5 in one of the same company's stores.

A recent twist had also emerged with the new category of Internet-enabled TVs. Movies and television shows could be viewed by linking these TV sets to the Web, and bypassing cable networks and their fees. Hulu, a joint venture by three major program content providers, was one such site; it was initially free but rumored to be on the verge of monetizing its service, possibly through microtransactions or highly competitive subscription rates. To take advantage, retailers were considering how to piggyback their retail brands onto Internet-enabled sets sold in their stores.

But consumers did not always embrace digital retailing. In glaring instances, people turned out to be deeply attached to the old land-based forms of shopping. Consumers stuck with their grocery stores despite saying in surveys that they would love the convenience of buying food electronically from Webvan or Peapod. Even though the national distaste for used-car salesmen was mythic, people still bought their next vehicle off the dealer's lot. One number summed it up: after nearly two decades of development, by 2009 all Internet-based buying still accounted for less than 6 to 7 percent of U.S. retail sales.

"Never Again"

Still, the writing seemed on the wall for certain product categories. Books, music, and movies were well down the digital retailing path already. New generations of consumers found it increasingly beside the point whether they got their content as a packaged physical product (a book, a CD, a DVD) or as intangible bits and bytes. Providers did not share consumers' indifference and met the challenge in varied ways.

Music labels resisted change, by and large. They continued to push expensive albums of songs based on the physical limitations of 33 rpm vinyl disks. They steadfastly maintained rigid copyright policies, in willful denial that, as new technologies made it effortless for consumers to copy music and share it with their friends, something would have to give. Not only did the labels blacken their image by punishing small-time violators, they failed to come up with new formats for retailing their content in ways that made sense to consumers and still made money for themselves. Ultimately, the market for legitimate commercial sales stopped growing and CD sales began to dwindle. Virgin Megastores and Tower Records evaporated. Then Apple Computer stepped into the breach. Its iTunes online retail store offered label-sanctioned purchases at 99 cents a song and immediately reconfigured digital music retailing. The damage was done. Remaining brick-and-mortar retailers of recorded music watched passively, refusing to look for alternatives that might have revived sales, partially out of fear that radical steps might undermine their conventional store formats. In hindsight they regretted their paralysis. As the music category moved solidly into the digital realm, traditional retailers began looking in earnest at other vulnerable categories and vowed, Never Again.

Movie studios began in a different position. Historically, motion pictures were not products that consumers could buy. They were services available only in movie theaters or, later, on broadcast television. Motion pictures became products first as videocassettes and then as DVDs. For a brief period, from the 1970s through the early 2000s, movies were retailed in stores or rented either at outlets such as Blockbuster, through the mail by Netflix, or most lately in tiny kiosks of top-sellers only by Red Box.

Trends were by no means clear, however. Box office sales in 2009 reversed direction for the first time since 2002, rising 10 percent to $9.9 billion, with even more gains promised by revived moviegoer interest in high-priced 3-D screenings of blockbusters such as the science-fiction/fantasy film "Avatar." Meanwhile, DVD sales continued to fall that year by 13 percent, to $8.7 billion. Eventually, however, movies would likely succumb to the same forces that had already hit music. Netflix was pioneering digital downloads, and pay-per-view was finally starting to seem practical, as mechanisms for financial microtransactions at last established the minimum viable commercial presence. At the moment, however, these new digital alternatives remained minor contributors. Of movies' overall $28 billion in industry-wide revenues for 2009, only $1.3 billion came from cable and satellite sales and rentals, and only $361 million came from Internet-based transactions. But growth rates in these electronic receipts contrasted sharply to broad stagnation in the market.

Boxed product was looking more and more obsolete. As before, land-bound retailers watched it all happening and vowed, Never Again.

Book publishers had something going for them that music labels and movie studios did not: people loved books as physical objects. They loved to feel them in hand, pull them from beach bags, and shelve them prominently in personal libraries. A lot of consumers, in short, wanted books to pull through the crisis. The first and biggest of online book retailers, Amazon, gave them hope by offering a radically different, brilliantly innovative retail format that blended undreamt-of online customer experiences with state-of-the-art drop-ship capabilities. Nevertheless, by 2010 it was by no means clear if books would fare better than music or movies. Would books still be books? Who would sell them, and where?

E-book readers such as Amazon's own Kindle were popping up like daisies; these reading devices were self-contained stores. Meanwhile, Google was scanning millions of books for free sampling by anyone with Internet access. Traditional retailers hadn't innovated their formats while they were ahead, and could only vow Never Again, again.

Next up for grabs would likely be video games, a lucrative entertainment category and the most technologically sophisticated. Would it be possible for brick-and-mortar incumbents not to lose this category as they had the others? Was it inevitable that the category would migrate away from a portfolio of offline and online retail formats? Indeed, did retailers have to assume that their current models had to be their future ones? Who was to say that a trusted brick-and-mortar retailer with innovative digital formats couldn't sell more effectively than players in the online-only world?

The Games Industry and Its Market

Video games, like any electronic product, came together for the consumer through an integration of hardware and software products and services. The game was software, but it had to be compatible with a specific family of hardware devices. Much like film studios in movies or recording labels in music, a publisher of video games might concentrate on designing content or on "distributing" it via the hardware platform device.

Consumers and industry experts alike evaluated video game product quality on a range of technical and creative dimensions. Creative assessments included the overall game storyline, design of the game's art and visual environment, its musical accompaniment, and the smoothness of its animations, character control, and artificial intelligence (what happened as the player made certain decisions). From a technical perspective, it was critical that the game perform exceptionally well on a consumer's chosen hardware platform. (See **Exhibit 7** for an illustrative new game review.)

Video games could be played either by individuals against the game itself, by individuals with separate controllers against each other, or by teams against other teams. Massively multiplayer online games (MMOGs) often pitted hundreds of players or teams against each other. Team members might be sprinkled around the globe, playing from any location having access to a high-speed Internet connection. By 2009 there was a strong trend to design games to permit such Internet-based competition. "Cloud computing," in which much of the processing power, storage, and game software was housed on remote commercial servers, was expected to become more heavily used for all sorts of digital entertainment, video games above all.

Market Size and Composition

Video game sales overtook other sectors of electronic entertainment in the late 2000s. In one two-year period when movie sales were growing slowly and total music industry sales had begun to decline, game-related sales registered 42 percent growth. Estimates for 2008 sales ranged from $10 billion to $13 billion for video game software alone. Even at the low end, this revenue surpassed both recorded music sales in stores and online (roughly $9 billion combined) and movie box office sales (just under $10 billion).

Folding in sales of consoles and accessories, the size of the overall game industry had reached $21 billion. Roughly 55 percent of this came from software, about 30 percent from hardware, and 15 percent from accessories.

Console sales rose and fell in large waves over cycles lasting several years from peak to trough, lengthening considerably by 2009 from an average of six years to nine. But games exhibited far spikier sales variations. Monthly sales volumes on a game often peaked in its first month—indeed *before* its first month in recent times, as online pre-selling became more and more popular. Following a pattern set by movies, most games faded from view soon after introduction. Publishers remained profitable only as long as one or two of their titles went blockbuster.

Eventually the global financial crisis of 2008 took its toll on all forms of electronic entertainment. Although games fought the economic downturn more successfully than almost any industry, by 2009 even their sales were hurt, dipping as much as 29 percent in one month against prior year sales. Accessories held up the best, actually registering slight sales gains in 2009.

The industry had evolved sufficiently that by 2009 most top-selling titles were new twists on previous hit games.

The Consumer Side of Video Games

An interesting 2009 academic study[1] found that the average American spent 11.8 hours per day outside of work consuming various types of data, images, and information. While television and radio still commanded more than 50 percent of that time, the next most popular activities for Americans on average were text messaging (14 percent) and video gaming (9 percent).

Best-selling console games fell into one of four categories, each holding strong appeal to its own distinct demographic group. The market for hardcore action games such as Activision's "Call of Duty" series or Midway Amusement's "Mortal Kombat" was composed overwhelmingly of boys and younger men. Family-friendly games presented the softer side of competition and were appropriate for kids of all ages. Fitness and activity games employed athletic equipment accessories to convert real-life movements into virtual-world results, e.g., swinging a golf club perfectly sent the ball 400 yards down the middle of an on-screen fairway. The fourth category, casual games, was somewhat hard to define, but generally meant easy to design and easy to learn. Casual games tended to be played more often on small screens and mobile devices. Target's share of such handheld games was twice its share of console games. Some important games—for example, the musical instrument–based Beatles Rock Band and Guitar Hero—crossed categories.

Consumers varied widely in what mattered to them when deciding how and where they would learn about, shop for, and manage their game products. And game usage was evolving rapidly in 2010. Hardcore gamers (HCGs), who had until then been virtually chained to their

[1] Roger E. Bohn and James E. Short, "How Much Information? 2009 Report on American Consumers," Global Information Industry Center, University of California, San Diego, December 9, 2009.

home consoles and big screens, were showing more interest in mobile games. Quite a few of them were starting to split their time between major-game "immersion," which offered lengthy, involved scenarios, and on-the-go "snacking" on fun little mobile app games that, for 99 cents or less, could be consumed in a few spare minutes and then discarded.

A recent survey revealed that 13 percent of white shoppers versus 22 percent of Hispanic shoppers agreed with the statement, "I am interested in shopping through my video game console."[2] Differences in consumers' underlying retail shopping needs were most evident in eleven broad areas: searching, evaluating, timing, ease, inspiration, enjoyment, advice, interaction, availability, assortment, and cost.

Competitive Dynamics

While video games could in theory be played on any electronic device with enough processing power and storage capacity, in practice most consumers saw *true* games as played on consoles, or in fewer cases, on personal computers. Consoles essentially were ultra-specialized, high-performance personal computers, minus the monitor, which was normally supplied by hookup to the family TV screen.

Just like personal computers and smart phones, consoles were turning into versatile, multifunctional platforms for all kinds of consumer activity, including DVD or Blu-Ray viewing, Internet browsing, and online movie streaming. Coming on fast were netbooks and tablet computers, which would soon combine adequate screen size and more than enough processing power to satisfy many sophisticated gamers who wanted the most visually intense, high-impact game anytime, anywhere. The iPad, a tablet device introduced in early 2010 by Apple, could prove to be a game changer.

All Big 3 console makers—Microsoft, Sony, and Nintendo—had enjoyed reigns at the top. But supremacy faded fast in this business, and the leader was usually displaced when a newer, better console concept appeared. Generally, aggregated games sales peaked several years into a console's lifecycle, reflecting games designers' wait-and-see approach before investing to develop new software titles, in case the platform fell flat with consumers. To get traction, console makers therefore made it a practice to subsidize development of one or two blockbuster games timed to appear on the market in tandem with the new platform. Microsoft had partially underwritten Halo, for instance, to give next-gen Xbox 360 buyers a razzle-dazzle new game.

In recent years, a rite had evolved in which addicted gamers showed up at a store to take possession of an eagerly anticipated blockbuster game at midnight of its "street day," or initial public sale. Like hot tickets to a rock concert or football game, these freshly marketed boxes were presold to gamers or gift-givers, often months in advance. Unlike movies, which stoked demand through promotional trailers, the quality and user experience of an unreleased game could only be guessed at. This created huge customer suspense and a scorching level of demand.

Retailers had to gear up to handle the surge, not only by stocking game inventory but loading up on accessories, signage, overtime staff, and dozens of operational imperceptibles. Games publishers and their console partners had evolved a whole alternative economics to cushion

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[2] Survey in May 2008 of 537 Internet users conducted by Greenfield Online and compiled by Mintel International Group Ltd.

retailers on the way down from the street day sales spike, using assumed margins and price protections to smooth over disrupted operations and cash flow volatility. Retailers had become oddly dependent on this arrangement, even as their suppliers, armed with point-of-sale data, imposed contractual penalties for any deviation off program. What would happen to retailer income statements and to prices should games move from physical distribution in stores to digital distribution through connected devices?

In any event, there were signs that consumers might be wearying of this model. Why, they asked, must we shell out hundreds of dollars for new platforms every few years? It no longer made sense, given rapid game obsolescence, need for hardware reinstallation, and availability delays as game developers caught up with the console.

As a result, by 2009 it seemed the industry was shifting away from big-bang introductions of all-new hardware platforms, and some experts predicted that game player device upgrades would be the main path going forward. Such upgrades were also a growing trend for the games themselves. Part of any publisher's motivation was to counter players' potential weariness with the same game environment by refreshing the material and keeping virtual worlds cutting edge.

By one estimate, gamers on average bought 7.3 new games and 3.2 used ones per year. Therefore, game publishers were motivated to depress demand for off-price used games, which had become a billion-dollar industry. If a game's "refreshability" could not be passed along to the next owner, the publishers' view held, its trade-in and resale value would undoubtedly be undermined. As the infrastructure to support downloading, streaming, and porting a game from one hardware platform to another matured, it seemed likely that GameStop and other retailers linked closely to used games would be seriously threatened.

Nonetheless, independent game publishers, even strong ones such as Electronic Arts and Activision, felt vulnerable to the power of console makers, and often characterized the Big 3 hardware manufacturers as excessively controlling. When all was said and done, a publisher needed to sell at least a million copies of any game that had been under development for twelve to eighteen months. With profitability riding on the size of licensing fees and division of marketing responsibilities, negotiations to "tie" a game to a console were often heated.

Brick-and-mortar retailers similarly felt under the thumb of the Big 3, primarily for margin reasons. While game margins were typically in the 15 to 20 percent range, and margins for hardware accessories such as headsets or cables could be as high as 80 percent, retailer margins on the consoles themselves were only around 3 percent. To hang on to the associated game and accessory product sales, retailers felt they had no alternative but to stock consoles. How much energy they would invest to sell them was another matter. (See **Exhibits 8** through **10** for snapshots of key retailers.)

Signs of Change

That was how the video game world appeared to retailing executives and experts in 2009. But the marketplace for video gaming—indeed for any digital interactive product—was nothing if not always in flux. A number of trends were materializing that promised to remake the traditional gaming business and its surrounding industry in profound ways.

Digital distribution. Given games' massive file sizes, downloading them in the manner of books, music, or even feature films was still impractical. But streaming them was already reasonably viable, as were online subscription services, which also had the commercial advantage of spreading consumers' payments over extended periods in smaller, less noticeable increments.

Cost advantages of digital distribution were also considerable. Industry analysts estimated that Netflix spent about 60 cents to mail a DVD to a consumer and pay for its return, while the company's outlay to stream that same film to the customer was only 5 cents. It seemed reasonable to assume that the same cost disparities would roughly translate into the games space.

Cross-platform mobility. Consumers desired, and were increasingly being given new options, to essentially leave off playing a game on one device and pick it up again later on another, in a kind of platform relay race that enabled gamers to fill in spare moments by pushing ahead to the next level of play, any time they felt like it.

Games as lifestyle. Console games, with their total immersion in flashy alternative worlds of wartime violence, sci-fi, and high-speed racing, were pushing into a new and unfamiliar realm: real life. Players could swing a golf club or dance the night away and then measure their performance, all in the privacy of their game room. Games were becoming a tool for improving fitness and exercising skills useful to personal development.

App stores. Apple had consolidated the clutter of neat little things you could do with your cell phone and presented the semi-organized bundle into a digital offshoot of its game-changing iTunes retail music emporium. But at a deeper level, the Apple App Store was struggling with success and had fallen behind on the longtime retail challenge of making a complex array of more than 100,000 applications practical and easy to shop.

Networked play. MMOGs were becoming highly popular with hardcore gamers and attracting more casual gamers as well. Such games required network connectivity via modem or mobile device. With networked play a given, the possibility of networked retail purchase and upgrading became a logical and perhaps not difficult extension.

Social gaming. Games were starting to open up to a new type of customer, "everybody but hardcore gamers" (EBHCGs). Good hand-eye coordination, strong thumbs, and killer instincts were no longer prerequisite to game enjoyment. Anyone—say, a mom with kids in school—could enjoy turning on the equipment during her free time because the name of the new-style game was collaboration: Supply a world of 73 million users with food (FarmVille, by Zynga). Run an upscale eatery with friends (Restaurant City, by Playfish). Or outfit your personal space station and colonize the future (Sony's newest platform, Home).

Trade-ins and used games. Games were no different than any other maturing category in which a market developed for product that some users were ready to discard as they moved on to better or merely fresher options. By 2009 used games represented one in every three games purchased, although they made up a much lower share of total game software revenues. Still, the growth of the used-games trade and its absolute status as a multibillion-dollar slice of all games sold meant that retailers had to pay more attention—and they were. Walmart and Target were taking trade-ins for store credit. GameStop, the leading specialist in used games, also resold them for up to 80 percent markup.

Old Rules, New Rules

There was a time when our online and offline businesses were viewed as being different. Now we are realizing that we actually have a physical advantage thanks to our thousands of stores, and we can use it to become number one online.

—Raul Vasquez, Walmart.com CEO, *Wall Street Journal*, December 15, 2009

Shopping at Amazon means you don't have to fight the crowds. We bring items to your doorstep. You don't have to fight through traffic or find a parking space. [But also] we know customers are not going to tell us one day that it is okay to send me my stuff a little slower.

—Craig Berman, Amazon.com spokesperson, *Wall Street Journal*, December 15, 2009

"Well, I was right about one thing," Eastman thought to himself back in his office as he looked over the agenda he was developing for the Target video gaming strategy offsite. "It isn't going to be enough to simply buy smarter and merchandise video games the way we do it now. Certainly not at Target Stores. Not even at my own area, Target.com."

To help his assembled offsite group delve into the issues with maximum productivity, Eastman felt it was important that everyone begin by seeing Target's overall business unconstrained by its current models. He decided on a quick refresher on the principles of Retailing 101, relevant even in digital or hybrid offline-online retail models. Basic terms in the 101 lexicon for Eastman included: segmentation and differentiation, customer experience and retail format, assortment curation and inventory management, and strategic vendor collaboration.

A Different Perspective

Eastman told his colleagues, "Let's take a step back. A few weeks ago I was talking with a marketing professor from the Kellogg School of Management. When I filled him in on what we've been doing recently, he made several comments.

"He told me that store-based improvements such as lower gondolas, new merchandising, re-located interactive displays, and tethered versus locked-up games were all good moves. Floor-level changes like these can pay immediate dividends and in the short run can even win some share from Walmart and Best Buy. Plus, they will boost Target's trust factor with moms.

"But he was curious to hear more about what Target was doing with the new generation of technology-enabled retail, and thought there must be exciting things that Target and Target.com could do with online, device, mobile, and who knows what other forms of shopping. What worked in the past, and what still works in other parts of the store, is going to work less and less well in digitally migrating categories. We're going to have to try harder than giving iPhone users an app for transacting with Target.com.

"Then the professor said something I hadn't given much thought to," Eastman continued. "His hunch was that we should be looking beyond the confines of the Target.com Web site. What's the online equivalent of lower gondolas, creative assortments, and improved interactive experiences?

"That struck me as a productive way to look at our situation. We know that as more and more moms turn to new digital shopping models, they will bring their same concerns about shopping intimidation, product appropriateness, assortment decision-making, and female-friendly experiences with them. How might we build powerful Target-style trust in how they shop in cyberspace?"

For a few seconds, no one spoke. Finally, Eastman cleared his throat. "To start things off, it may help to recall two mantras that every marketing MBA is taught.

"One B-school mantra is *different strokes for different folks.* Segments of customers are so fundamentally distinct from each other that there will always—always—be room for a retail format that speaks better to a major segment's needs. GameStop is a perfect example in video games; they go after HCGs and don't waste much effort on anybody else. Our own store, Target, is *the* segment-focused mass merchandiser. And we will continue to be, so long as we stay creative and out in front of our priority shoppers, whether that means better brick-and-mortar, better Target.com, or some all-new hybrid experience. It just has to mean, better for them."

Nik Nayar spoke up. "It's likely that the shopping needs of some key Target customers *are* changing, their behaviors are changing, and new segments are forming as a result. History shows these segments will migrate quickly to progressive formats. But none of this is easy to detect yet. We should be suspicious of averages. We have to dig beneath them to find emerging segments related to volatile areas like online shopping or video games."

"The second mantra of retailing down through the ages," Eastman resumed, "has been *location, location, location.* That hasn't changed. In fact, for us working on the Internet it might be truer than ever. What's brand new here is that we're seeing a reversal of direction. The best location used to be one where customers would come to us, willingly and easily.

"Now the best 'location' is individual customers themselves. We have to go to them. Target.com already does this to a limited extent in the usual digital ways, and it will keep finding new spins to add. But we may be able to go beyond that. Winning retailers in the hybrid online/offline world where consumers increasingly live will take new format models right to the customer. They'll be the ones who figure out how to catch the customer at the right moment: the moment of need. They may even ask the customer to invite them in before they enter. I'd love it if our customers invited Target first."

"The Kellogg professor made a related point. He pointed to the differences between Web 1.0 and the new Web 2.0 digital revolution. The first wave of businesses on the Internet put up 'online catalog' Web sites, the same way they would present a store, and crammed these stores with vast SKU assortments to take advantage of inventory management economies.

"But the professor explained that in Web 2.0 much of conventional shopping activity moves out of the store *per se.* In the best of all possible worlds, people shop where they happen to be. Maybe they're using their mobile device, maybe they're in the midst of a social activity, chatting with friends or playing a round of golf, maybe they're playing a Wii fitness game. Location, in other words, ideally sits between an ongoing series of lifestyle activities. In this Web 2.0 world, the store, if there is one, is located on the device or nearby. Consumers say, 'I'll look for it on my iPhone'—or my Xbox or my Internet TV, or e-Reader, or tablet, or whatever."

"And when they look there," Mike Heller cut in, "moms especially might find a trusted friend like Target is their best choice. The corollary challenge is helping moms that do shop us for video games become multichannel Target customers with other cross-channel buying behaviors."

"They might," Eastman agreed. "Maybe you should run with this idea."

"We've more or less publicly committed to do that already," Steve Orzel noted. "After all, our recent decision to stop outsourcing Target.com's online activity to Amazon implies that we're thinking about something even better. And better than Amazon is a pretty high bar."

"This has been productive," Eastman concluded. He then summed up their discussion as a $64,000 question:

> *Looking out five years, how do we make sure we have* future-proofed Target *with a next-generation retail format for the emerging supercategory of electronic products—games, movies, music, books, software, and applications—that is proprietary, differentiated, and sustainable for the segments of consumers who know and trust us?*

Key Strategic Questions

"Here's your immediate assignment for the offsite," Eastman told Nayar, Orzel, and Heller. "I'd like each of you to make a case for what you think Target should do. Respond to my $64,000 question, then dig in to these subsidiary issues:

- Looking out three to five years, propose a detailed path for refining or radically redefining Target's place in the overall landscape of online and offline approaches to video game shopping. Be prepared to address such key strategic issues as:
    - What value proposition will differentiate Target with attractive segments of future video game shoppers?
    - What sustainable advantages can we build through gaming product curation and improved shopping experiences for core consumers?
    - What mix of retail formats do you recommend, and how do they fit together?
    - What will it take to reach your end-state for how Target reaches video game consumers? What new investments or competencies are required?
    - What steps can we take to defend our future position against encroachment by conventional and emerging competition in gaming?
- Defend your proposed Target strategy for gaming products with regard to the company's current retail situation, answering:
    - What impact does your proposed strategy have on Target's profitability and growth as the gaming industry evolves?
    - How does it make up for any loss of "conventional" revenue tied to long-term category trends over the next three to five years?

- What are the strategic implications for Target's current conventional store and online businesses?
- How can any conflicts or transitional concerns between Target stores and new online or hybrid offline-online formats be addressed going forward?
- What implementation challenges might limit Target's buyers, floor staff, and commercial partners from moving through the steps together on schedule?

- Make clear what your key assumptions are with regard to inputs from any of Target's vendors to your proposed strategy:
  - What specific role would Target's gaming products or service providers play in your proposed strategy?
  - What risks does your strategy raise with vendors, and how should Target manage these risks?
  - How should Target structure its games-related alliances and partnerships, and how should it take the lead in managing its value chain?

"The idea is to give some dedicated thought to creating a new offline/online business video games retail model geared to consumers' rapidly changing needs. Frame your answers in Retailing 101 terms: segmentation and differentiation, customer experience and retail format, assortment curation and inventory management, and strategic vendor collaboration. Sell me. I want to know how I can continue to feel excited about the future of Target's whole business, from the point of view of the video games category.

"Alright, time to head home," Eastman said as everyone packed their gear into the SUV. "Thanks in advance for thinking hard and differently about Target's retailing model. We still have some time before Target's current offline and online formats become obsolete—but not forever. Let's develop a good pitch to sell change at the offsite. The games category is just too profitable for us to let slip."

Exhibit 1: Target.com, the Virtual Storefront

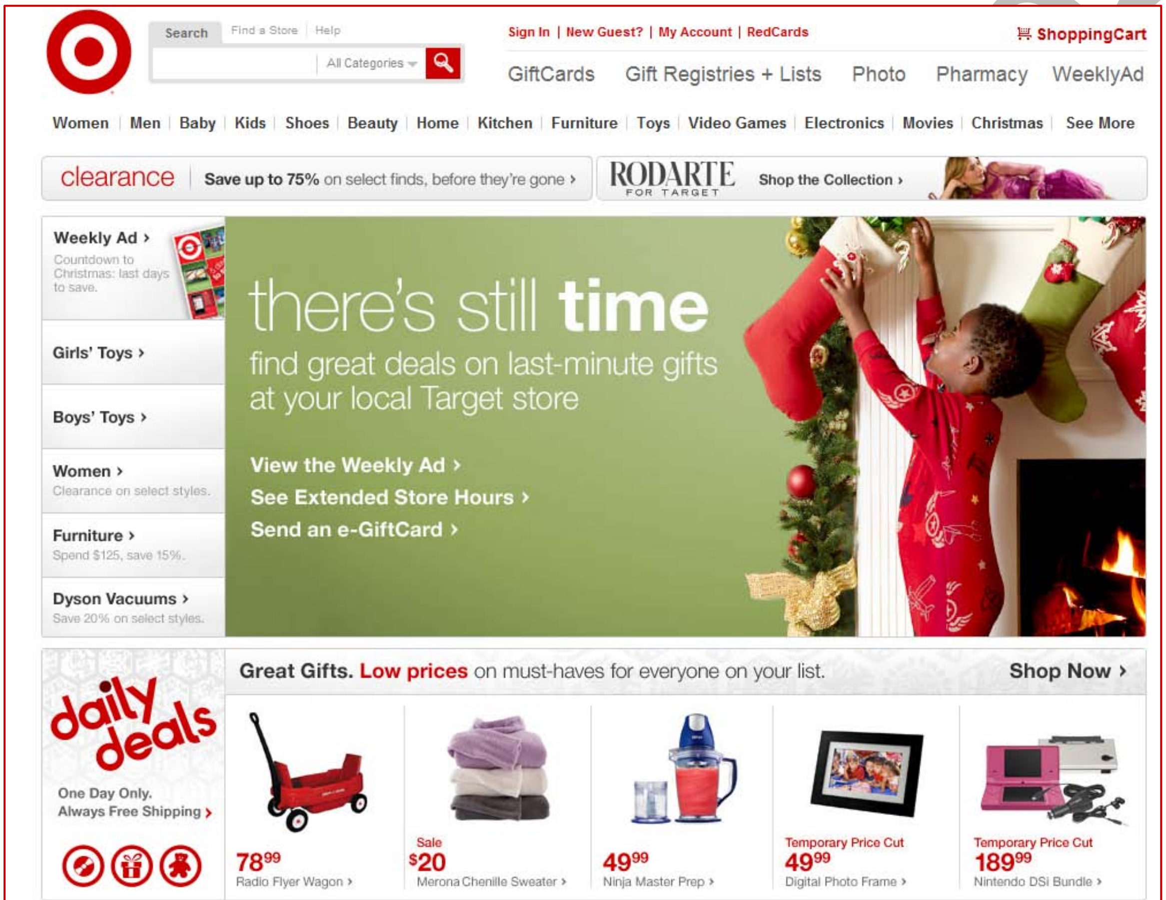


Exhibit 2: Target Corporation Financial Results, 2003–2008

Financial Summary: Continuing Operations	2008	2007	2006[a]	2005	2004	2003
FINANCIAL RESULTS ($ IN MILLIONS)						
Sales	62,884	61,471	57,878	51,271	45,682	40,928
Credit card revenues	2,064	1,896	1,612	1,349	1,157	1,097
Total revenues	64,948	63,367	59,490	52,620	46,839	42,025
Cost of sales	44,157	42,929	40,366	35,788	32,226	29,057
Selling, general, and administrative expenses[b]	12,954	12,670	11,852	10,324	9,016	7,989
Credit card expenses	1,609	837	707	776	737	722
Depreciation and amortization	1,826	1,659	1,496	1,409	1,259	1,098
Earnings from continuing operations before interest expense and income taxes[c]	4,402	5,272	5,069	4,323	3,601	3,159
Net interest expense	866	647	572	463	570	556
Earnings from continuing operations before income taxes	3,536	4,625	4,497	3,860	3,031	2,603
Provision for income taxes	1,322	1,776	1,710	1,452	1,146	984
Earnings from continuing operations	2,214	2,849	2,787	2,408	1,885	1,619
PER SHARE						
Basic earnings per share	$2.87	$3.37	$3.23	$2.73	$2.09	$1.78
Diluted earnings per share	$2.86	$3.33	$3.21	$2.71	$2.07	$1.76
Cash dividends declared	$0.62	$0.54	$0.46	$0.38	$0.31	$0.27
FINANCIAL POSITION ($ IN MILLIONS)						
Total assets	44,106	44,560	37,349	34,995	32,293	27,390
Capital expenditures	3,547	4,369	3,928	3,388	3,068	2,738
Long-term debt, including current portion	18,752	16,590	10,037	9,872	9,538	11,018
Net debt[d]	18,562	15,238	9,756	8,700	7,806	10,774
Shareholders' investment	13,712	15,307	15,633	14,205	13,029	11,132
RETAIL SEGMENT FINANCIAL RATIOS						
Comparable-store sales growth	(2.9)%	3.0%	4.8%	5.6%	5.3%	4.4%
Gross margin rate (% of sales)	29.8%	30.2%	30.3%	30.2%	29.5%	29.0%
SG&A rate (% of sales)[e]	20.4%	20.4%	20.3%	19.9%	19.6%	19.4%
EBIT margin rate (% of sales)	6.5%	7.1%	7.4%	7.5%	7.2%	7.0%
OTHER						
Common shares outstanding (in millions)	752.7	818.7	859.8	874.1	890.6	911.8
Cash flow provided by operations (in millions)	$4,430	$4,125	$4,862	$4,451	$3,808	$3,188
Revenues per square foot[f,g]	$301	$318	$316	$307	$294	$287
Retail square feet (in thousands)	222,588	207,945	192,064	178,260	165,015	152,563
Square footage growth	7.0%	8.3%	7.7%	8.0%	8.2%	8.8%
Total number of stores	1,682	1,591	1,488	1,397	1,308	1,225
General merchandise	1,443	1,381	1,311	1,239	1,172	1,107
SuperTarget	239	210	177	158	136	118
Total number of distribution centers	34	32	29	26	25	22

[a] Consisted of fifty-three weeks.

[b] Also referred to as SG&A.

[c] Also referred to as EBIT.

[d] Including current portion and short-term notes payable, net of domestic marketable securities of $190, $1,851, $281, $1,172, $1,732, and $244, respectively. Management believes this measure is a more appropriate indicator of Target's level of financial leverage because marketable securities are available to pay debt maturity obligations.

[e] New account and loyalty rewards redeemed by Target shoppers reduce reported sales. The retail segment charges these discounts to the credit card segment, and the reimbursements of $117 million, $114 million, $109 million, $98 million, $80 million, and $67 million, respectively, are recorded as a reduction to SG&A within the retail segment.

[f] Thirteen-month average retail square feet.

[g] In 2006 revenues per square foot were calculated with fifty-two weeks of revenues (the fifty-third week of revenues was excluded) because management believes that these numbers provide a more useful analytical comparison to other years. Using revenues for the fifty-three-week year under generally accepted accounting principles, 2006 revenues per square foot were $322.

Source: Target Corporation.

Exhibit 3: Target Stores Productivity Analysis

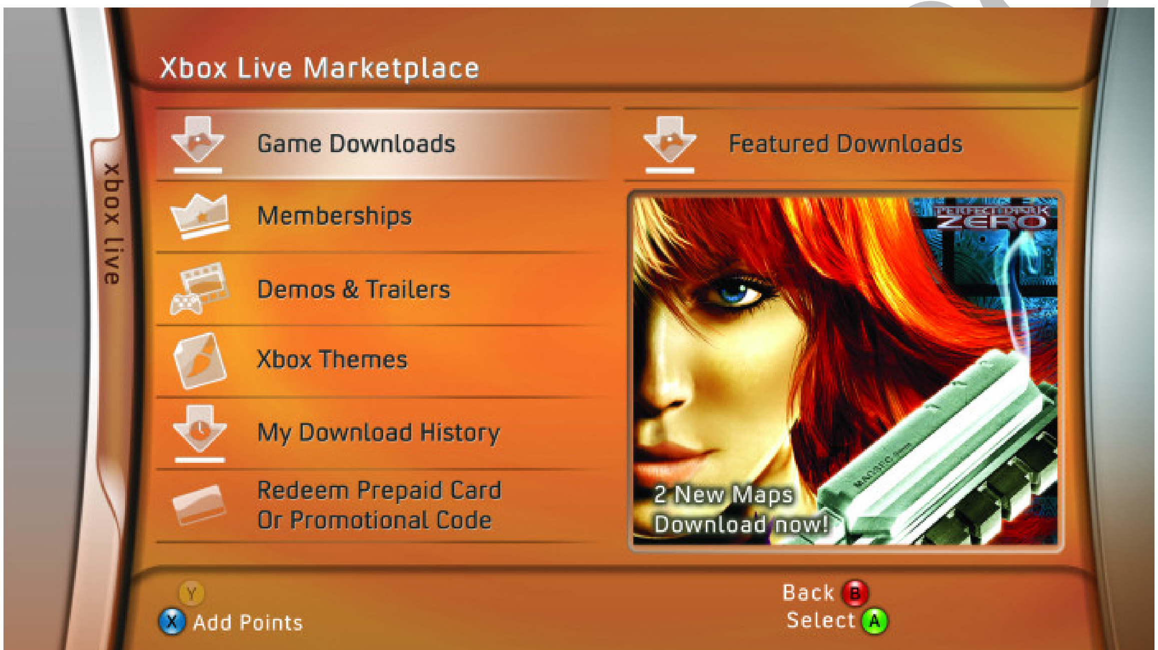
ANALYSIS OF TEN ILLUSTRATIVE CATEGORIES AT TARGET
(INDEXED TO AVERAGE FOR GROUP)

	Square Footage	Total Sales	Sales Per Foot	Contribution Per Foot
Interactive entertainment	0.94	1.54	1.55	1.30
Carbonated beverages	0.23	0.37	1.51	1.06
Movies	1.17	1.54	1.25	1.81
Dairy	0.53	0.52	0.92	0.77
Personal care	1.58	1.50	0.90	1.01
Perishables	0.79	0.71	0.85	0.53
Audio electronics	1.25	1.04	0.79	1.30
Baby	1.39	1.14	0.78	0.17
Candy	1.26	0.98	0.74	0.95
Cameras	0.87	0.66	0.72	1.09
Average for these ten categories	*1.00*	*1.00*	*1.00*	*1.00*

Source: Target Corporation.

Exhibit 4: New Retail Model? Game Console Sales Platforms (Illustrative)

"MARKETPLACE" RETAIL PLATFORM ON MICROSOFT'S XBOX 360 CONSOLE



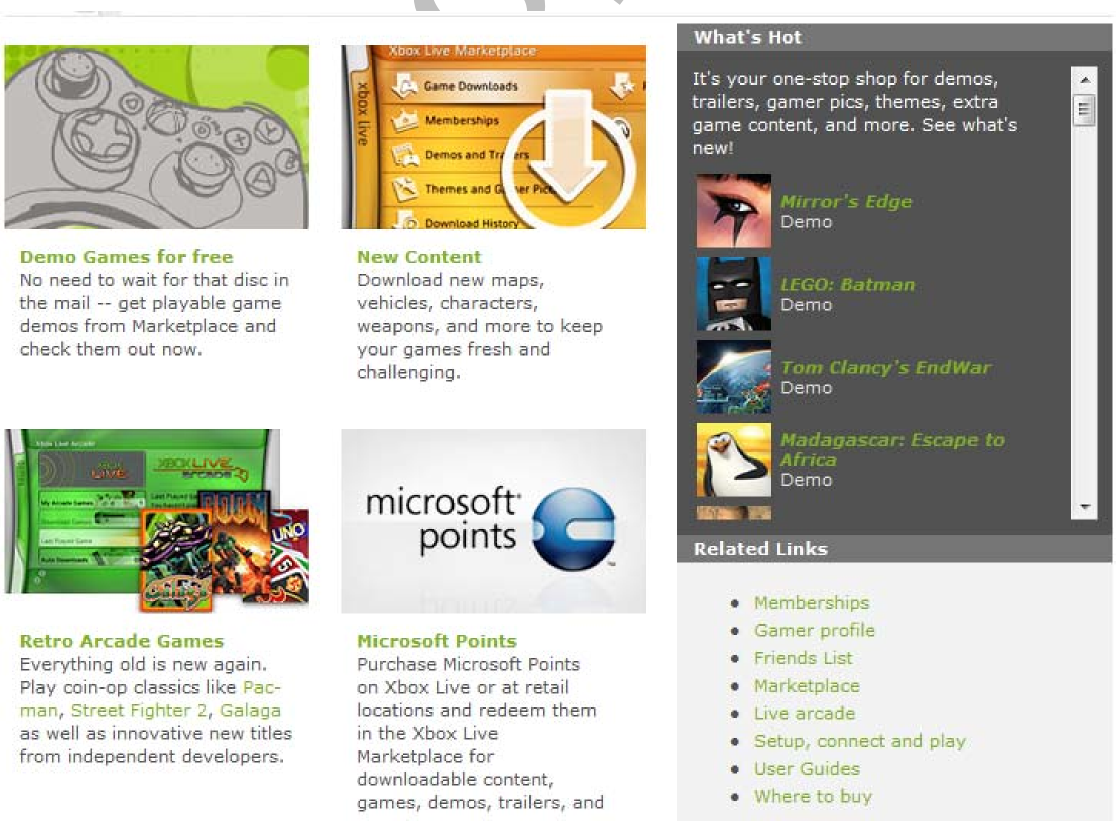


Exhibit 5: New Retail Model? Smartphone Sales Platform (Illustrative)

"APP STORE" RETAIL PLATFORM ON AN APPLE iPHONE

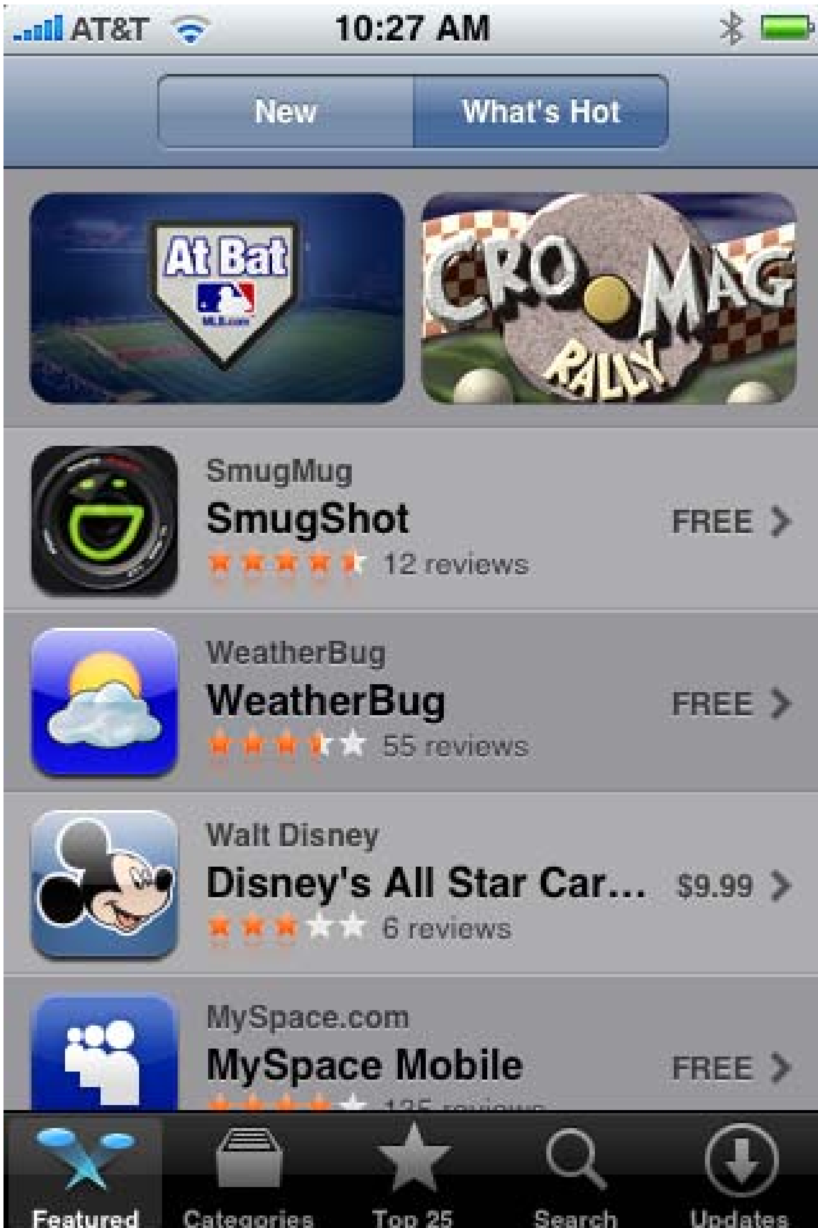


Exhibit 6: New Retail Model? Streaming Inet Game Sales Platform (Illustrative)

ONLIVE RETAILS TO CONSUMERS ON THE INTERNET

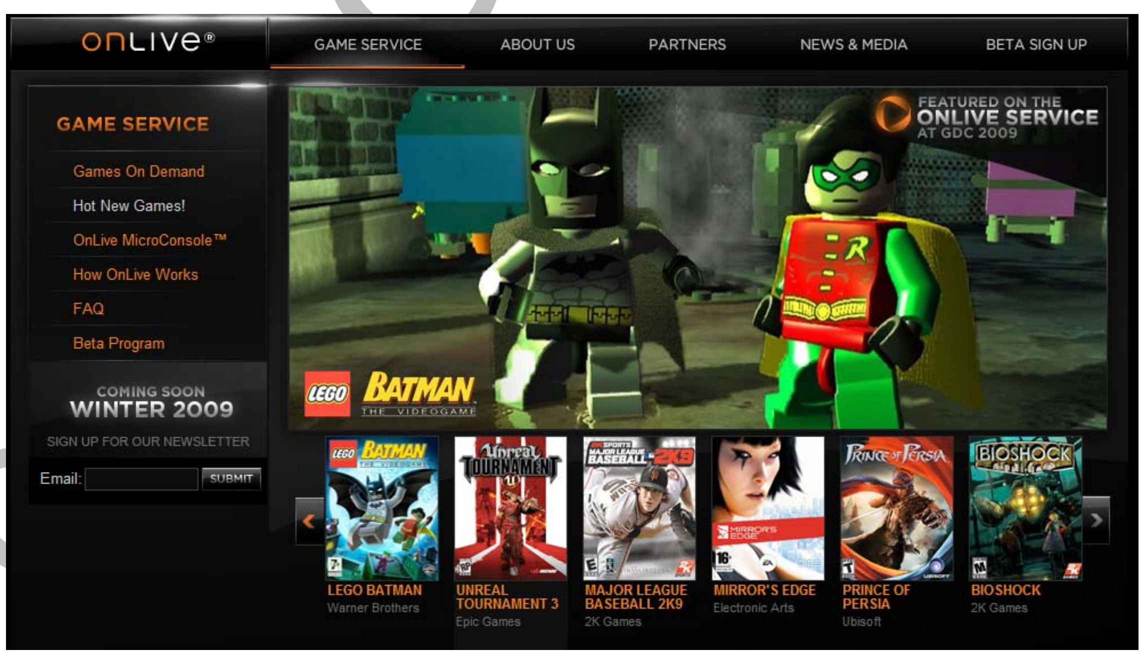


Exhibit 7: New Game Product Review (Illustrative)

EARLY REVIEW OF AVATAR: THE GAME (DECEMBER 2009)

Fighting an Enemy Crisis With Very Little Energy

Seth Schiesel, *New York Times*, 12/18/09 [edited for reduced length]

It always helps to be beautiful, but good looks really can only get you so far in life. Even among the professionally ogled, it seems that some measure of intelligence, attitude, and depth is what distinguishes the compelling elite from the merely attractive. In that sense James Cameron's Avatar: The Game is like an aspiring model who will never make it on a big-time runway. It is extremely easy on the eyes and is certainly well put-together, but it is also thoroughly vapid, wholly generic in its sensibility, and utterly devoid of any emotional or intellectual engagement.

The new Avatar game is not offensively bad, but it also does nothing particularly to engage players besides throwing pretty pictures of jungles at them. Mr. Cameron appeared to want the Avatar game to stand on its own as a top-end interactive entertainment experience. It does not. I haven't seen the film "Avatar," but I'm hoping that it is built around interesting, even moderately complex characters exploring a varied, diverse world as part of a nuanced, provocative story line. Because none of those elements exist in the Avatar game.

The game allows you to play through two separate campaigns as either a human or Na'vi warrior, a great idea. But the game completely botches the execution of that idea by forcing the player to choose a side very early in the game before any of the stakes, in terms of either story or the game, have been established.

To begin, the voice acting is some of the worst I've heard in a game this year—stilted, mechanical, and straight from cliché central. Are the actors in the film voicing the game? The two campaigns feature quite different game-play styles, with different weapons and vehicles and special skills, but the controls are imprecise, and the basic combat systems are thin.

Almost all of the missions consist of the same rote commands: go here, kill everything in your way, retrieve the shiny doodad, come back. [The] actual outdoor environments are poorly designed in terms of actually letting you move around. In other words, you can't see where you're supposed to be going half the time. Technically, the game is solid. But solid is not sufficient.

It is worth recalling how Mr. Cameron touted the game in 2007. "*For the movie 'Avatar' we are creating a world rich in character, detail, conflict, and cultural depth. It has the raw material for a game that the more demanding gamers of today will want to get their hands on—one that is rich in visuals and ideas, and challenging in play. I told the Ubisoft team I wanted them to be free to do their very best work, and not think of this as a movie-based game. They responded with a fully realized presentation, which captured the soul of the world and the characters, while promising to be a knockout game on its own terms. Their passion inspired my confidence that they are going to do something transcendental.*"

Far, far from it. All this game does is stand around and look good.

Exhibit 8: Brick-and-Mortar Video Game Retailer—Best Buy

Exhibit 9: Brick-and-Mortar Video Game Retailer—GameStop

Exhibit 10: Online Video Game Retailer—Amazon