On June 21, 2016, Tencent, the Chinese mobile internet giant spent $8.6 billion to purchase 84.3% stock of Supercell, the wildly profitable Finnish firm behind hit games Hay Day, Clash of Clans, Boom Beach and Clash Royale. This was Tencent’s largest overseas deal ever. While it has bought other gaming firms including the one in 2015 e.g. Riot, the maker of the online battle game “League of Legends,” this acquisition is far larger. As most analysts have assumed, given Tencent’s long-standing dependence on game revenue in PC era, at one level, this deal indicates the continuing importance of games to Tencent strategy. However, this misses the important fact that in Chinese market, Tencent’s true customer acquisition strategy is centralized around QQ, which is its PC chat platform, and WeChat, the smartphone chat platform, and its increasingly important e-payment system. Tencent today is no longer a game company and not even a simple chat-based social network.

We suggest that Tencent is developing a “platform business group” (PBG) model based strategy as many other Chinese firms. The PBG model exploits synergies created by linking the constituent businesses to cross-market services. To demonstrate, we briefly explain its PBG model, and Tencent’s transformation from an online gaming company into a PBG. In addition, we explore the reasons why Tencent bought Supercell and explain their possible scenarios for future business strategies.

Chinese PBG Strategy in Mobile Internet Era

Business groups are firms linked to one another by ownership and equity ties that mutually reinforce each other through various forms of preferential treatment. The typical Silicon Valley firms have rarely developed business group models. The western firms instead try to create dependent ecosystems with complementarities, as is illustrated by the operation of the app stores, YouTube, Facebook, etc. To illustrate, despite Google’s various offerings including Search, Gmail, Drive, YouTube, etc., the key synergies for Google are assembling a more complete profile of its users. The data from these different user profiles, across multiple platforms, can be sold to advertisers. Furthermore, Google leverages an enormous data center capacity. Their products and services are, in fact, relatively loosely coupled. To illustrate if you want to embed a map in Gmail, it need not be from Google Maps. Google’s business model leverages its core source of revenue, search/advertising through the wide variety of properties/platforms that provide data collection synergies. While Google has expanded to other sectors, the multiple platforms have not resulted in a variety of revenue models. The most important exception is the Android OS, which when certified requires preloading of various Google functions and, of course, has direct synergies with Google Play store. In China,
the Android OS’s developed by Chinese firms are not certified and do not preload other Google functions. Due to the pressure from competition authorities, Google’s search/advertising and Android/App Store have been required to remain relatively independent from each other. Most of the other US Internet firms have adopted a similar strategy, and have organized their business models into vertical silos with a single revenue model. Of course, as we can see, this business model has been enormously successful.

**Platform Business Group of Tencent**

The Chinese mobile internet leaders, in contrast to Western firms such as Google and Facebook, have created multiple platforms that operate with different business and revenue models. These models are predicated upon cross-platform traffic feeding and often use cross-subsidization to penetrate markets. Rather than independent platforms and respective assets cultivating in different markets, these platforms cross-feed one another to develop synergies, and build complicated networks in the hopes of excluding challengers and providing users a wide variety of services within the walled garden/ecosystem. In the PC era, the two most important Tencent services were instant messaging, QQ, and its game platform, Tencent Game. Most of these games were developed and produced by Tencent. By leveraging its huge user on QQ, Tencent Game became a powerful distribution channel and games became its main revenue source.

The mobile Internet, which in China has grown to 700 million users, created challenges and opportunities. First, in contrast to PC game world, the application store became the new distribution channel for mobile games. With Google Play blocked in Mainland China, there was space for an Android OS app stores. The smartphone manufacturer, Xiaomi, was one of the first movers when it introduced Mi-Talk – a direct threat to the dominant position of QQ. In 2011, Tencent introduced WeChat, which was immediately successful and allowed it to retain its leadership in instant messaging. WeChat rapidly evolved into a platform providing an ever-wider variety of services including payments, social network, e-commerce, advertisements, and games distribution. In 2015, WeChat reached 549 million monthly active users. With the success of WeChat, Tencent integrated functions that initially were complementary, for example, WeChat Payment function. Tencent not only leveraged the huge mass of users of WeChat to promote its payment service. Moreover, it aggressively expanded and acquired stakes in or launched other business platforms such as coupons (Groupon), reviews (Yelp), JD (a competitor to Alibaba), etc. to speed adoption and extend the walled garden.

In addition to WeChat and Payment, the Games Platform was ported from the PC and was integrated into the business group cross-traffic strategy. On one hand, traffic on Tencent’s dominant social network was guided to Games Platform to strengthen its position. On the other hand, Tencent’s games platform was organized to feed traffic to its other platforms, like MyApp, the largest Android app store in China owned by Tencent. To illustrate, some very popular Tencent games are only available on MyApp, thereby building the market share of the app store.

Effectively, Tencent created a business group consisting of social network, payments, and games, each using a different revenue model. Despite the fact that currently games still make-up a relatively large share of total revenues (48% at 2016Q2) for the entire group, ad revenue based on WeChat social network has increased to 10.4% and is growing twice as fast as gaming. While Tencent does not disclose the precise volume of transaction fees collected through WeChat payments, it already garners 20% of all mobile payments in China – trailing only Alibaba’s Alipay. The remaining revenues come from its various PC-oriented businesses.

While Tencent has had great success in China, its sites have not been successful globally. Tencent and WeChat have not been successful in displacing Line (in Japan), Kakao Talk (in Korea), and Whatsapp, Snapchat and iMessage (in the rest of world). While China is an enormous market, Tencent has had little success in the international market. Further, Tencent is always threatened with the possibility that competitors may develop disruptive games that could be used to encroach upon its dominant gaming market share.
Why Acquire Supercell

The acquisition was an enormous commitment of capital and thus is a significant risk for Tencent. The obvious reasons for the acquisition have already been discussed such as the fact that Supercell is currently enormously profitable, for example, an EBIT of 40% in 2015. Due to their tremendous EBIT Supercell has become the 9th most important company for Finland national economy with a share of 0.5% of Finland gross domestic product in 2015. To illustrate, the significance of Supercell, in 2015 Nokia’s share of Finnish gross domestic product was 1.3%.

For Tencent, there were two other strategic incentives, which are linked to its evolution into a PBG:

First, with the acquisition, Tencent cemented its dominant position in the Chinese game market, while also strengthening its global presence. The Chinese market is, of course, all important for Tencent. Prior to the acquisition, Supercell’s games were published by Kunlun and distributed by 360, which is the 5th largest domestic Internet firm. Clash of Clans was so popular in China that it allowed 360 to challenge Tencent. The acquisition was a decisive response to this challenge. Moreover, when Supercell’s sales are included, Tencent will control 13% of the $100 billion global games market cementing its global leadership in online games.

Second, the Tencent transition to a business group strategy, driven by the fact that ads and transaction fees are much larger markets means that Supercell can reinforce these growth areas. Tencent has already begun serving targeted ads on WeChat and collecting transaction fees from the payment platform. The problem is that, so far, WeChat has failed to gain traction in the global market. One question is whether Supercell could be used to promote WeChat in Western markets. To speculate, if users can only download “Clash of Clans” on WeChat, or if some functions of “Clash Royale” are custom-tailored for WeChat, such as sharing a game gift with WeChat friends, then there might be a way to convince game users in other countries to, at least experiment with WeChat. While this might be difficult, there can be little doubt that WeChat has world-class chat functionality. Such a move would be in keeping with Tencent’s Chinese business group strategy where the goal is to create cross-platform synergies.

Third, after the Tencent acquisition, Supercell announced that it planned to open game design studios in other European nations and invest in other Finnish gaming companies. This may assist Tencent in finding new games that it can market in China, while also assisting in its growth of income outside of China.

Conclusion

This acquisition is not without risks to both Supercell and Tencent. Despite the possibilities, Tencent is making a large wager given the uncertainties.

The first uncertainty is obvious. Namely, can Supercell maintain its creativity and continue to produce popular games? It has repeatedly been the case that developers have declined after being acquired by other firms or undertaking an IPO. If Supercell fails to sustain its ability to create hits, any synergies Tencent hopes to create will not occur.

Second, the ability of Tencent to balance the tradeoff between WeChat and Supercell is uncertain. As we stated, Tencent might be able to integrate some custom-tailored functions into Supercell games to promote WeChat. However, this tactic could harm user experience if not carefully designed and implemented.

Third, because of the nature of Tencent’s existing games, we doubt that the Supercell’s global distribution network will provide significant leverage for distributing Chinese games. This may change in the future if Tencent can develop or find original games in the Chinese ecosystem that have global appeal, but this seems unlikely at this time.

Fourth, there may be opportunities for technological cooperation as Supercell has developed some interesting technologies. Perhaps, Tencent’s global-class chat technologies will contribute to further improvement of Supercell’s existing in-game communication technologies.

Fifth, it might be possible for the two firms to develop combinations of real-life data and vir-
tual games. Given their complementary assets, by integrating Supercell’s games into its platform business group Tencent is certain to generate profitable synergies in the Chinese market. It is less certain that Supercell can assist Tencent in increasing its presence in the global market beyond the mere addition to its existing income streams. The true measure of success for Tencent will be whether it can use Supercell to further its global ambitions.

Finally, to speculate even further, the competition authorities in western nations are likely to prohibit bundling of specific services and discriminate against other similar services, as has been the case with the litigation against Android/Google in Europe. This makes it unlikely that Tencent’s PBG model is viable in western economies. However, given the unresolved anti-trust problem surrounding multi-sided platforms, as well as the relative small market share of Tencent in the EU and the US, it might still be possible to see Tencent leverage its Supercell acquisition. What is certain is that the acquisition will give Tencent synergies in China and provides it with an important position in the international game market.

References
