

Technical Analysis

Zynga – Needs energy boost

Bloomberg | Reuters | Poems
ZNGA US | ZNGA O | ZNGA

Phillip Securities Research Pte Ltd
10 July 2012

Trading Call : i. Avoid → ii. Watch → iii. Maybe Buy
Close : \$5.24
Support : \$4.78
Resistance : \$8.00

Chart 1: Dec 2011 – June 2012 Zynga Daily Chart



Source: Bloomberg

The technical indicator for Zynga shows it is in a downtrend. The chart has declined since March 2012. The descent is becoming more gradual indicating an easing in selling pressure but this is not an indicator to buy as selling pressure can resume easily. To buy, we need a strong technical indicator coupled with rising volume or an accumulation period.

Fundamentals

Company Overview:

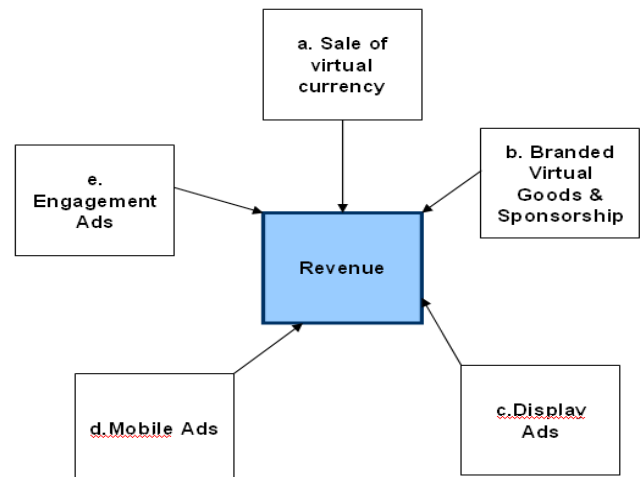
Zynga Inc. said it is the world's leading provider of social game services with 240 million average monthly active users (MAUs), in over 175 countries. Zynga develops, markets and operates online social games as live services played over the Internet and on social networking sites (mainly Facebook) and mobile platforms. Popular games include Mafia War, Farmville and Zynga Poker. Unlike most game developers which require consumers to pay for the game first, Zynga games are free to play but for a player to advance in the game quickly, he will have to use real money to purchase virtual currency which is used in turn, to purchase virtual goods.

Having sold down below its IPO price and made a new 52 week low at \$4.78 in June, Zynga does not appear to have a firm support even at \$4.78. Overhead resistance is about \$8.00.

The absence of a sharp angle in the down slope and the narrowing in price range does not make Zynga a good stock to short. At the current price level, it looks more like a drifter than a mover in either direction. Hence our advice will be to avoid the stock – for now.

We have to watch the stock for signs and because of the developments in the company's business direction, we may be able to take a buy position. Hence our trading call, to avoid, to watch and maybe buy.

Chart 2: Zynga's Sources of Revenue



Source: Phillip Securities Research, Company

- a. Sale of virtual currency;
- b. Branded Virtual Goods and Sponsorships that integrate advertising within game play;
- c. Engagement Ads and Offers in which players can answer certain questions or sign up for third party services to receive virtual currency;
- d. Mobile Ads through ad-supported free versions of our mobile games such as Words with Friends ;
- e. Display Ads in our online web games that include banner advertisements.

A typical Zynga game goes like this: A player starts off with a small amount of virtual currency and a full energy bar. The player has to perform tasks to earn money, special points or items. Energy is required to perform each task and when the energy level is diminished, a player may replenish the energy either by waiting for it to recover or use real cash to purchase special points/cash to get energy. Zynga strategy panders to players' need for instant gratification and/or vanity. The hares want it fast and are more willing to purchase virtual currency to climb ranks within the game quickly or to attain special items which no one else has. But for those who are unwilling or unable to spend real money on the game, they will advance simply through the passage of time. Tortises do not mind a slower game play by waiting for the energy bar to recover or for tasks to be completed. Zynga's challenge is on how to keep its 240mn MAUs interested enough to want to spend on the game.

Zynga's social games have got the recipe right judging from the revenue and cash flow figures. As the leader in social games, it attained immense success only through Facebook. Zynga has huge revenue streams. If we strip out R&D expenses, pre-tax incomes were -\$1.78mn, \$276.5mn, \$320.9mn for FY09, FY10 and FY11 respectively. Operating cash flows were \$191mn, \$326mn and \$389mn.

What made Zynga games attractive?

Before the rise of social games, players usually have to pay for a game before they can play. Be it an adventure, action or strategy game, there is often an end to the game. A player typically engages in game play alone. Some games may be so difficult that walkthroughs are required to advance.

Zynga games are free to play from beginning to end. The end is almost endless if you consider levels 1 to level 999. Even at level 999, game credits do not roll and players are not made to restart. Being a social game, players are required to invite their friends to the games. More friends mean more gifts and faster advancements in levels. Games are very easy to play with no serious fighting, magic or difficult puzzles.

Free to play, easy and endless are attributes which lower the bar for many players into the almost mindless games and promote their stickiness to these games.

We believe the optimal strategy for Zynga is to innovate and build player stickiness to current stable of games which

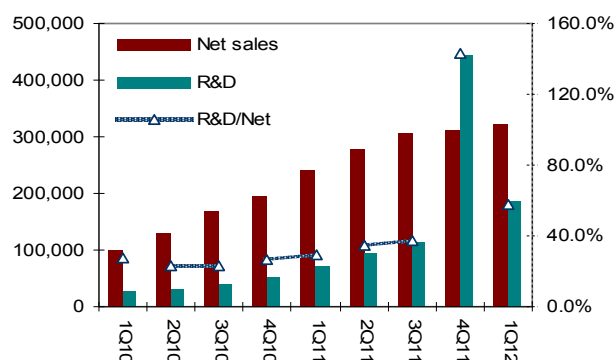
account for the bulk of their earnings. Zynga could also allocate a percentage of earnings to R&D to develop new games while evaluating games by external developers for their potential to be hit games. This strategy is in fact similar to the one enlisted by big pharmaceutical companies - staple drugs, new drugs and potential acquisitions. Only companies with a strong suite of social games can use this strategy because for most other game developers, their operations are more akin to those of movie producers – always looking for the next big hit.

The structure or stickiness of social games alone should encourage investors to own some of these companies' shares. However, Zynga shares have been slipping and for good reasons.

i. Inability to control costs.

Zynga research and development expenses were \$727.0 million, \$149.5 million and \$51.0 million in 2011, 2010 and 2009, respectively, which included stock-based compensation of \$374.9 million, \$10.2 million and \$1.8 million, respectively. R&D expenses represent a high percentage of revenue.

Chart 3: R&D Spending (USD\$'000)



Source: Phillip Securities Research, Company

ii. buy, BUY, BUY

Zynga had spent ~\$147 mn for 22 companies in 2010 and 2011. Recently, it paid \$180 million to acquire OMGPop Inc. The CEO said he expects to do a few deals the size of OMGPop or larger in the next 3-5 years. In the past, Zynga's strategy was to buy little known team of developers but they are now targeting developers with more popular games. Buying is easy for a firm flushed with cash but retaining talent could be a problem as founders from six startups had reportedly left, according to Bloomberg Businessweek.

iii. Wider share base but narrower earnings

Zynga did a secondary offering on April 3, 2012. About 49.4mn Class A shares were offered. All stockholders of this tranche have to hold their shares in moratorium for 90 days.

iv. Over reliance on Facebook

More than 90% of Zynga's revenue is from Facebook

Table 1: 1Q10-4Q11 Zynga bookings and revenue

Facebook bookings	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11
Bookings	94%	93%	91%	93%	93%	93%	94%	93%
Revenue	94%	93%	91%	94%	93%	93%	93%	94%

Source: Phillip Securities Research, Company

In Zynga's 2011 AR, some of the challenges pertaining to its tie up with FB are if:-

- Facebook discontinues or limits access to its platform;
- Facebook modifies its terms of service to Zynga's disadvantage.
- Facebook changes how the personal information of its users is made available to application developers on the Facebook platform or shared by users;
- Facebook establishes more favorable relationships with one or more of Zynga's competitors; and/or
- Facebook develops its own competitive offerings.

v. Difficulties moving into mobile social gaming

Most of Zynga games which are played on FB have difficulties moving into mobile app space as FB itself has difficulties monetizing mobile users. Zynga poker however is one of the top downloaded games in Apple app store.

vi. Competitive Industry

Zynga attempts to introduce games via social networks, mobile and PCs. The competition in each of these segments is relatively tough.

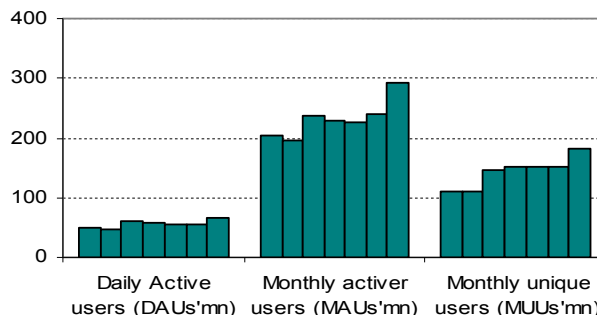
- game developers for FB/other social networks: Crowdstar, Inc., DeNA, Electronic Arts Inc., King.com, The Walt Disney Company, Vostu, Ltd. and wooga GmbH,
- Mobile game market: Apple, Electronic Arts, GREE, DeNA Co. Ltd., Gameloft, Glu Mobile, Rovio Mobile Ltd and Storm8, Inc.
- PC games: Activision Blizzard, Inc., Big Fish Games, Inc., Electronic Arts, SEGA of America, Inc., THQ Inc. and The Walt Disney Company.

Social games appear to be quite easily replicated for in the mobile app space, Smurfs' Village by Capcom and Zombie Farm by Playforge, are some of the popular social games with characteristics similar to Zynga's social games.

vii. IF.. fail to retain players' interests

Zynga's games can be annoying with the frequent pop-ups prompting players to buy virtual cash with real money. Not only must Zynga be able expand the base, it has to retain the players' interest too.

Chart 4: 1Q10-1Q12 Users data (mn)



Source: Phillip Securities Research, Company

Why some say Buy?

Current fundamentals, near term earnings and management strategy for expensive acquisitions are warnings signs to stay away from the stock.

Yet, of the 14 analysts who cover Zynga, 13 have buy calls, 10 holds and 1 sell with a 12 month target of \$11.15. This calls for a doubling of capital if the analysts' are accurate.

Most analysts with buy calls believe Zynga poker will benefit from the recent approval for online gaming in US. But this approval depends on each individual state and competitors, including companies with physically run casinos, are plentiful. Even though Zynga poker is popular on the app store, Zynga has no actual experience running real casino online and there are plentiful of red tapes involved as online gaming is newly approved by US DOJ.

We have our doubts and we prefer to adopt a wait and see approach even though Zynga share price had fallen by more than 60% from its peak.

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FYE Dec	FY09	FY10	FY11	1Q12
PE (X)	n.a.	47.6	n.a.	n.a.
PB (X)	n.a.	3.6	0.9	2.1
Per share data (USD)				
EPS, reported	-0.31	0.11	-1.40	-0.12
DPS	0.00	0.00	0.00	0.00
BVPS	n.a.	1.46	6.06	2.51
Growth & Margins (%)				
Growth				
Revenue	n.a.	391.9%	90.8%	3.1%
EBIT	n.a.	337.7%	-423.3%	-82.4%
Net Income, adj.	n.a.	271.5%	-546.3%	-80.4%
Margins				
Gross margin	53.3%	70.5%	71.1%	71.9%
EBIT margin	-43.5%	21.0%	-35.6%	-26.7%
Net Profit Margin	-43.5%	15.2%	-35.5%	-26.6%
Key Ratios				
ROE (%)	n.a.	18.8%	-23.1%	-4.8%
ROA (%)	n.a.	8.1%	-16.1%	-3.3%
Net Gearing (X)	n.a.	net cash	net cash	net cash
Income Statement (USD\$'000)				
Online Game	85,748	574,632	1,065,648	292,780
Advertising	35,719	22,827	74,452	28,192
Net sales	121,467	597,459	1,140,100	320,972
Cost of sales	56,707	176,052	330,043	90,122
Gross Profit	64,760	421,407	810,057	230,850
Operating expenses				
R&D	51,029	149,519	727,018	186,876
Sales and Marketing	42,266	114,165	234,199	56,837
General & Admin	24,243	32,251	254,456	72,715
Total Op. exp	117,538	295,935	1,215,673	316,428
Operating Income	-52,778	125,472	-405,616	-85,578
Other income and exp	-32	1,587	-526	149
Interest and dividend income	177	1,222	1,680	1,291
Other expense, net	-209	365	-2,206	-1,142
Income before provision for income taxes	-52,810	127,059	-406,142	-85,429
Provision/(benefit) for income taxes	12	36,464	-1,826	-78
Net income	-52,822	90,595	-404,316	-85,351

Source: PSR

FYE Dec	FY09	FY10	FY11	1Q12
Balance Sheet (USD\$'000)				
PPE		74,959	246,740	255,251
Intangibles		104,218	123,877	339,222
LT marketable sec		0	110,098	458,731
Other LT assets		27,181	12,022	7,341
Total non-current assets		206,358	492,737	1,060,545
Accounts Receivables		79,974	135,633	146,746
Investments		550,259	225,165	701,662
Cash		187,831	1,582,343	361,074
Others		88,150	80,768	335,919
Total current assets		906,214	2,023,909	1,545,401
Total Assets		1,112,572	2,516,646	2,605,946
Accounts Payables		33,431	44,020	44,312
Others		487,219	624,665	660,202
Total current liabilities		520,650	668,685	704,514
Others		109,707	98,422	73,042
Total non-current liabilities		109,707	98,422	126,062
Shareholder Equity		482,215	1,749,539	1,775,370
Cashflow Statement (USD\$'000)				
PBT	-52,810	127,059	-406,142	-85,351
Adjustments	14,616	19,268	716,066	164,811
Cash from ops before WC changes	-38,194	146,327	309,924	79,460
WC changes	229,201	216,549	77,422	-643
Cash generated from ops	191,007	362,876	387,346	78,817
Tax benefit/(paid), net	-12	-36,464	1,826	0
Interest (paid)/receive	0	0	0	0
Cashflow from ops	190,995	326,412	389,172	78,817
CFI				
CAPEX, net	-39,949	-120,194	-284,657	-220,335
Dividends from associates & JVs	0	0	0	0
Dividends/Interest from Investments	0	0	0	0
Purchase/sale of investments	-62,740	-480,500	210,794	-831,868
Investments in subs & associates	0	0	0	0
Others	-703	-16,744	10,408	-224,952
Cashflow from investments	-103,392	-617,438	-63,455	-1,277,155
CFF				
Share issuance	0	0	961,403	0
Purchase of treasury shares	0	-1,484	-283,770	0
Loans, net of repayments	0	0	0	0
Dividends to minority interests	0	0	0	0
Dividends to shareholders & capital reduc	0	0	0	0
Others	14,169	352,921	391,211	-22,967
Cashflow from financing	14,169	351,437	1,068,844	-22,967
CCE, open	25,564	127,336	187,831	1,582,343
Effects of exchange rates	0	84	-49	36
Net change in cash	101,772	60,495	1,394,512	-1,221,305
CCE, end	127,336	187,831	1,582,343	361,074

Source: PSR

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