Zynga (ZNGA)

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Stock Price: $3.50
Diluted Shares: 804.1MM (diluted sharecount up 7% Y/Y – these guys have no problem handing themselves stock)
Diluted Market Cap: $2.8BN
Cash & Marketable Current Assets: $1.2BN
Long-Term Marketable Securities: $426MM
Debt: $0
Other Liabilities: $208MM
EV: $1.4BN

The image at the top of this post is a tad misleading. You see, Zynga is a battleground stock.

Bulls will say: this is just like Groupon before it gained 150%; the company has been left for dead, there are too many bears; new CEO Don Mattrick has 6 months under his belt now and he's going to (a) do a big cost cut and (b) start to unveil a new line-up of games starting mid-year; don't bet against Mark Pincus or this Board.

Bears will say: casual gaming is not a viable strategy in the long term; there's no moat in this business; their best employees simply leave to start a competitor; they are too dependent on FB; the turnaround will fail; how can you trust an admitted scammer who wastes money on lavish parties and has a history of destroying shareholder value?

Intellectually, I side with the bears. But the truth is probably somewhere in-between.

Here's the recent story arc:

As 2013 began, Zynga seemed determined to turn things around, largely by cutting costs. In February 2013, it shuttered satellite offices in Baltimore, New York, and Texas.
It launched real-money gaming in the United Kingdom two months later—only to shut it down by July 2013. That was the same month that founder and CEO Mark Pincus stepped down as chief executive, replaced by Don Mattrick, a longtime Microsoft veteran.

In its Q2 2013 earnings statement filed with the Securities and Exchange Commission, Zynga reported that the number of daily average users (DAU) dropped to 39 million in the second quarter of 2013—the lowest ever since the company began keeping track. In the first quarter of 2013, the DAU fell to the then-lowest record, 52 million users. The fall to 39 million means that 25 percent of its daily user base stopped using Zynga products in just one quarter. By mid-August, new CEO Mattrick fired three top executives.

Michael Pachter, an analyst with Wedbush Securities, told Ars. "I can't imagine what 3,000 employees did there. They're down to 2,300. They need to be down to 1,000. They can't afford to have 1,500 people working on new projects. Don will run the company like a business. He may figure out how to get the right cost structure."

It's not [the economy or any rival game company] that's destroying Zynga; Zynga is destroying Zynga. Last week, I would have said I was despondent, but now, after the [June and August 2013] layoffs, I would say I'm cautiously optimistic." - Anonymous Zynga principal engineer

Source: http://arstechnica.com/business/2013/09/how-zynga-went-from-social-gaming-powerhouse-to-has-been/4/

On 16-Jan-14, the stock took a nosedive after a Sterne Agee analyst went to AppData.com and pointed out a downward sloping graph and projected that into the future. Will he be right about 2014? Who knows. The answer will be driven by the titles Zynga is developing today and launching at some unknown point in the future.

Here's what we do know:

If you take EV and subtract the value of the corporate building they purchased in 2012 ($234MM), you can see the market is valuing the business at $1.2BN. Here's what you get for $1.2BN:

- 48 gaming titles, many are distributed through Facebook, some are also distributed via mobile – though ZNGA is making a concerted effort to have a more balance distribution approach.
    - **From the last 10-K:** Facebook is currently the primary distribution, marketing, promotion and payment platform for our games. We generate a significant portion of our revenue through the Facebook platform and expect to continue to do so for the foreseeable future. For the twelve months ended December 31, 2012 and 2011, we estimate that **86% and 93% of our revenue**, respectively, **were generated through the Facebook platform**, while 13% and 4% of our revenue, respectively, were generated through mobile platforms.
    - **From the last 10-Q:** Facebook is currently the primary distribution, marketing, promotion and payment platform for our games. To date, we have derived a significant portion of our bookings (65% in the three months ended September 30, 2013) and revenue (**77% in the three months ended September 30, 2013**) and acquired substantially all of our players through Facebook. We expect to continue to derive a significant portion of our bookings and revenue from the Facebook platform for the foreseeable future.
- 133MM monthly active users, though this is an extremely volatile number. The key data point for ZNGA is MAUs (Monthly Active Users); this is their measure of audience size. Higher MAUs, more revenue via in-game purchases and advertising (ZNGA's only 2 revenue sources; purchases are ~85% of revenues). As you can see, MAUs took a nosedive in 2013 – from almost 300MM in 4Q12 to 133MM in 3Q13. The monetization of users has stayed fairly consistent (see the row titled 'ABPU') so the real issue at ZNGA

is user count, driven by hit games.

	For the Three Months Ended							
	Dec 31, 2012	Sep 30, 2012	Jun 30, 2012	Mar 31, 2012	Dec 31, 2011	Sep 30, 2011	Jun 30, 2011	Mar 31, 2011
	(dollars in thousands, except ABPU data)							
Other Financial and Operations Data:								
Bookings	$261,269	$255,606	$301,588	$329,164	$306,507	$287,661	$274,743	$286,598
Adjusted EBITDA	$ 45,018	$ 16,154	$ 65,309	$ 86,752	$ 67,801	$ 58,130	$ 65,080	$112,263
Average DAUs (in millions)	56	60	72	65	54	54	59	62
Average MAUs (in millions)	298	311	306	292	240	227	228	236
Average MUUs (in millions)	167	177	192	182	153	152	151	146
Average MUPs (in millions)	2.9	2.9	4.1	3.5	2.9	2.6	NA	NA
ABPU	$ 0.051	$ 0.047	$ 0.046	$ 0.055	$ 0.061	$ 0.058	$ 0.051	$ 0.051

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(users and payers in millions)			
Average DAUs	30	60	40	66
Average MAUs	133	311	191	303
Average MUUs	97	177	123	184
Average MUPs	1.6	2.9	2.0	3.5
ABPU	$ 0.055	$ 0.047	$ 0.052	$ 0.049

Note that ABPU stands for Average Bookings Per User. Bookings is revenue recognized during the period plus the change in deferred revenue during the period. ZNGA records the sale of virtual goods and mobile downloads as deferred revenue and then recognizes that revenue over the estimated average payer life or as the virtual goods are consumed. Advertising sales, which consist of certain branded virtual goods and sponsorships, are also deferred and recognized over the estimated average life of the branded virtual good, similar to online game revenue.

The astute will then ask: hmmm… so if deferred revenue is recognized over the life of a user, can the "life of a user" figure be adjusted by management to report better numbers? The answer is yes.

From the last 10-Q: *"changes in our estimated average life of durable virtual goods during the nine months ended September 30, 2013 for various games resulted in an increase in revenue of $7.3 million in that period, which is the result of adjusting the remaining recognition period of deferred revenue generated in prior periods at the time of a change in estimate. For the same period in the prior year, <u>changes in our estimated average life of durable virtual goods resulted in an increase in revenue of $22.0 million</u>."*

So this is something to watch – in the last Q, the estimated weighted-average life of durable virtual goods was 12 months (compared to 15 months in 2011). A movement down would suggest the company is "managing" their earnings.

To continue, for $1.2BN you also get:

- Approx. 2,500 employees.

- Intellectual property / trademarks / brand identities.
- A revolving credit agreement of $200MM through June 2018.
- Cash flows from operating activities, which have been:
  - 2010: $326MM
  - 2011: $389MM
  - 2012: $196MM
  - First 3Qs of 2013: $21MM – <u>note that the company was negative $5MM in operating cash flow in 3Q13</u>

	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13
Bookings	$286,598	$274,743	$287,661	$306,507	$329,164	$301,588	$255,606	$261,269	$229,815	$187,578	$152,106
MAUs	236.0	228.0	227.0	240.0	292.0	306.0	311.0	298.0	253.0	187.0	133.0
Avg Booking per MAU	**$1.21**	**$1.21**	**$1.27**	**$1.28**	**$1.13**	**$0.99**	**$0.82**	**$0.88**	**$0.91**	**$1.00**	**$1.14**
Operating Cash Flow	$103,657	$74,061	$47,495	$163,959	$78,817	$67,024	$30,147	$19,779	$26,445	($645)	($4,858)

- CapEx in this business is related to data centers / computing equipment / infrastructure. This investment cycle appears largely complete (no need to invest in "a better user experience" when the number of users is falling like it is):
  - 2010: $57MM
  - 2011: $238MM
  - 2012: $98MM
  - First 3Qs of 2013: $7.3MM
    - Interestingly, in the 2012 10-K, the company said: "In 2013, we expect to make capital expenditures of up to <u>**$48 million**</u> as we invest in network infrastructure to continue to improve the player experience." But in the most recent Q, the company said: "For the full year ended December 31, 2013, we expect to make capital expenditures of <u>**up to $10 million**</u>."
    - It appears like the company has become much more cognizant of how it spends money. Now, if they could only stop making stupid acquisitions like OMGPOP, which burned $200MM and yielded very little for the company. I have to think any more of this activity wouldn't be tolerated by shareholders and today's management would be reluctant to pursue additional acquisitions but you never know.

So let's think about 2 of the possible outcomes for ZNGA (there are more, but these appear to be the most likely given visibility of the company and prodding by Wall Street):

1. They come out with a hit game and the key driver of their business – MAUs – reverses course and shoots up. As long as MAUs average 150MM or more, they should be able to produce breakeven (or better) cash flows, even with their currently bloated staff count.
2. They announce large layoffs, retrench and try to remain cash flow positive.

The key thing to note is that in either scenario, Zynga has lots of cash ($1.6BN) which buys them lots of time. As Randy Pausch said, "time is all that matters" – it gives their engineers space to create new products and it gives investors the opportunity to get in / out as the news flow inevitably moves from negative to positive and back.

But I want to dig a little deeper and try and frame where ZNGA might end up if things go poorly (scenario #2). The costs in ZNGA's business are:

- **Cost of revenue:** 3rd party hosting, data center and customer service costs (driven by MAUs), D&A (non-cash) and payment processing fees (driven by MAUs). These things are all flexed off MAUs. Lower MAUs, lower cost of revenue. There are also costs for employees that run the infrastructure; these can be flexed, but certainly not like the first group of costs.
- **R&D:** salaries and stock based comp for engineers and developers plus allocated overhead.
- **Sales & Marketing:** online marketing costs plus the salaries of marketing employees / 3rd party marketers. Also included here is branding / PR costs and allocated overhead.
- **G&A:** salaries and stock based comp for executive, finance, legal, IT, HR and other administrative employees.

One way to triage where these costs would settle out is to see what happened from 3Q12 to 3Q13 (~500 employees were let go within that year and costs started to be managed better by the company).

As MAUs went from 311MM in 3Q12 to 133MM in 3Q13:

Cost of revenue dropped $30MM versus the year ago quarter and is now run-rating $240MM
R&D dropped $75MM and is run-rating $320MM
S&M dropped $15MM and is run-rating $84MM
G&A dropped $1MM and is run-rating $136MM

Total = decrease of $121MM versus the year ago quarter, now run-rating $780MM

These numbers give us some insight into what widescale layoffs would mean to the company. If letting go of 500 employees and watching costs a little closer means $120MM in savings per quarter (nearly $500MM per year), what would letting go of 1,500 more employees mean?

Let's assume G&A gets cut only $10MM and S&M can only be cut another $20MM / yr. That's $190MM in annual costs for those 2 line items. Let's also assume engineering / development really gets purged and costs are cut by 40% there – that's another $190MM in annual expenses. So total costs are $380MM for everything except the cost of revenue, which has averaged 25% – 30% as a % of sales since 2011 (but that includes a non-cash depreciation charge).

So what revenue and MAU count would you need to breakeven assuming the above cost cuts? Here's my math:

Revenue	$388
Cost of Revenue	$189
R&D	$190
S&M	$64
G&A	$126
EBIT	**-$181**
Add Back: D&A	$129
Add Back: Stock Based Comp	$52
Cash from Operations	**$0**
Average Booking per MAU / Yr	$4.30
MAUs to Breakeven	**90.2**

So you need approx. $390MM in annual revenue and 90MM Monthly Active Users to breakeven on a cash flow basis. And don't forget: cash buys time. Even if you dropped to $300MM in revenue (70MM MAUs), ZNGA would only lose $90MM / year. Drop to $200MM in revenue (47MM MAUs) and ZNGA loses $190MM / year. **Given their cash balance, ZNGA can operate for 8.5 years with less than 50MM MAUs**.

Seems like enough time to buy them a comeback.

There are a few things I'd like to see before going long for a trade:

1. On the operational front, either:
    1. A hit title, or
    2. An announcement of large layoffs
2. Insiders buying; they have been sellers of ZNGA's stock all the way down: http://www.insidercow.com/history/company.jsp?company=znga&B1=Search%21

My spreadsheet is here.

Sources:

SEC Filings: http://investor.zynga.com/sec.cfm

10-K: http://investor.zynga.com/secfiling.cfm?filingID=1193125-13-72858&CIK=1439404