Has Zynga Lost its Zing?[1]

Zynga's first few months as a publicly listed company had much less zing than many investors had hoped for. Zynga's initial public offering took place on December 16, 2011. The IPO was priced at $10/share, but finished its first day of trading down 5%. The price slowly climbed over the next few months, peaking at just over $14 in March of 2012, but had dropped back below the IPO price by late April of 2012. At least one analyst attributed this stock price slump to weak sentiment heading into Zynga's lock up expirations, recommending that investors take the opportunity to overweight the stock.[2] Yet many risks remained, not least of which was Zynga's struggle to 'monetize' its large and growing user base.

Zynga was the domestic leader in the rapidly growing domestic social gaming market, attracting over 60 million users a day. Its hit games, including FarmVille and CityVille, were keeping hooked users online for hours. Zynga was also able to exploit Facebook's social network as a marketing tool by enabling existing users to encourage their Facebook friends to try out Zynga's games. One key business issue, however, was that most users didn't pay for the gaming service. The service was provided free of charge and revenue was instead generated primarily through the optional purchase of 'virtual goods' that were designed to enhance the gaming experience. Yet only a very small proportion of users chose to purchase any goods, with the rest enjoying the service for free. Another risk was that consumer demand for gaming software could be fickle. Competitors from the established packaged gaming market, such as Electronic Arts, had already found that success required continued new product updates and releases to keep users hooked. Zynga also had to successfully navigating the shift to 'mobile',

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[1] This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation.

[2] "Zynga Inc., CQ1 Bookings Beat, Acquisition Raises Guide" Scott Devitt et al., Morgan Stanley Research Report, April 27, 2012.

whereby Zynga's target audience was rapidly shifting its social networking from desktop computers to mobile devices such as phones. These factors led to a tremendous divergence of opinions about Zynga's prospects. While some sell-side analysts saw the $10 price point as a buying opportunity, short positions in Zynga's stock grew to one third of the tradable shares, suggesting that sophisticated hedge fund investors thought it to be overvalued.

Zynga's 2011 Form 10-K and related case materials (including Electronic Arts 2011 Form 10-K) are provided as online exhibits at http://www.lundholmandsloan.com/new%20cases.html. Use this information to answer the following questions:

QUESTIONS

Business Strategy Analysis

1. A key element of Zynga's business strategy is its affiliation with Facebook. Identify the key benefits and risks associated with Zynga's affiliation with Facebook.

2. Identify and explain the key challenges to the profitability of Zynga's business model.

Accounting Analysis

3. Describe the accounting policies that Zynga uses in the recognition of revenue generated from the sale of virtual goods within its games.

4. Assume that instead of using these accounting policies for revenue recognition, Zynga instead recognized revenue when it received the associated cash. Estimate the Income (loss) before income taxes that Zynga would have reported for the 2011 fiscal year.

5. Describe the accounting policy that Zynga uses for research and development expenditures.

6. Assume that instead of using this accounting policy for research and development expenditures, Zynga instead capitalized research and development expenditures in the fiscal year in which they were incurred and then amortized them on a straight-line basis over the subsequent two fiscal years. Estimate the Income (loss) before income taxes that Zynga would have reported for the 2011 fiscal year.

7. Which of the above two accounting policies for research and development expenditures do you think better reflects the underlying economics of these expenditures at Zynga. Briefly justify your answer.

Financial Analysis

8. Compute operating margin ratios for Zynga and Electronic Arts for the 2011 fiscal year.

9. Briefly identify the primary reason(s) for the difference between the operating margins that you computed above?

10. Estimate the average number of days that elapsed between (i) the receipt of cash from the sale of goods and services and (ii) the recognition of the associated revenue for Zynga and Electronic Arts during the 2011 fiscal year.

11. Briefly identify the primary reason(s) for the difference between the average number of days for Zynga and Electronic Arts that you computed in the question above.

Forecasting & Valuation

12. A prominent sell-side analyst research report forecasted that Zynga's revenue would grow from 1,140.1 in 2011 to 4,083.2 in 2020. Evaluate the plausibility of this forecasting assumption.

13. Load the data in the 'Zynga data for eVal' file into *eVal* (Note: The case data is available at http://www.lundholmandsloan.com/new%20cases.html; open the data file, copy the yellow data block, and then 'Paste Special-Values' into the corresponding block of yellow cells at the bottom of *eVal*'s 'Financial Statements' worksheet). Select a valuation date of April 27, 2012. Critically evaluate the default valuation provided by *eVal*.

14. Adjust the forecasting assumptions and valuation parameters within *eVal* to represent what you consider to be most appropriate. Provide justifications for the forecasting assumptions and valuation parameters that you have selected. How does the resulting valuation in *eVal* compare with the Zynga's IPO valuation of $10? Try to identify the reason(s) for any major difference.