Buy Zynga

David Gardner | April 18, 2019 | Buy Recommendation

CURRENT PRICE: ZNGA $ 9.76 ↑ $ 0.32 (3.3%) ĆwȁǴı Ÿr B≈ÃÖǴ ̃Äm ÄÄ ı İN ŭ

A decade ago, online social gaming was a new concept. But if you asked someone at the time what "social gaming" meant, they were likely to have one answer: "FarmVille!"

This immensely popular game was introduced in the summer of 2009 by the company I'm recommending today, **Zynga** (NASDAQ: ZNGA). Launched exclusively on **Facebook** (NASDAQ: FB), it gained over 6 million daily players its first month; within six months it had over 80 million monthly active users. The company was so tightly linked with Facebook that around the time of its 2011 IPO, *Business Insider* referred to Zynga as "basically Facebook's outsourced games arm."

Less than three months after it went public, Zynga peaked at a market capitalization of $11.7 billion. But the excitement was short-lived. *FarmVille* went into decline, and heavy insider selling pushed shares down sharply. In November 2012, Zynga cut its ties with the social network.

And that's where we pick up today. Investors have largely abandoned Zynga, shares of which have mostly traded between $2 and $4 for the better part of seven years. Yet the company's decision to go it alone is the best one it could have made. Now with a market cap under $5 billion, Zynga has quietly accomplished a turnaround while everyone's backs were turned, and we think it's set to become an increasingly successful — and profitable — leader in mobile games.

Extra Life

FarmVille actually wasn't the company's first game. That honor goes to *Zynga Poker*, launched in 2007. While it never reached quite the dizzying heights of *FarmVille*, it has proven much longer-lived. In fact, it remains today one of the largest poker sites in the world.

ZYNGA IN 1 MINUTE

WHAT IT DOES

Zynga develops, markets, and operates social games for mobile and Web platforms.

WHY YOU SHOULD BUY

- After a long string of losses and uneven growth, Zynga has completed a turnaround that should set the stage for a rapid increase in profits.
- The company's free-to-play business model has created long-lived franchises with consistent revenue that the company can build on.
- New games based on *Harry Potter*, *Game of Thrones*, and *Star Wars* are coming out in the next year.

BUYER'S GUIDE

- **Industry:** Entertainment
- **Size:** Mid Cap
- **Region:** Global
- **April 16 Price:** $5.36
- **Allocation:** Don't buy too much of this stock just because it has a low share price! Decide what percentage of your portfolio you want to dedicate to Zynga, not how many shares. Many Fools choose to start with a small amount — 2% of their portfolio's

The company refers to this as a "forever franchise" — a game or family of games that generates over $100 million in annual bookings for five years or more. Its other "forever franchises" include *Merge Dragons!*, *Empires & Puzzles*, *Words With Friends*, and *CSR Racing*. Still others are on their way to reaching this status, like *Hit It Rich! Slots*, which brought in about $67 million in revenue last year (not counting associated advertising revenue).

While early investors saw Zynga as a one-hit wonder, management focused on refining the strategy it pioneered: free-to-play games that attract millions of users, monetized through advertising or in-game purchases.

It's a great model. As CEO Frank Gibeau recently put it, "we can create advertising context that the players love." Beyond pushed banner ads, the company will make "watch-to-earn" offers, giving players virtual currency and bonuses if they choose to watch an ad that is typically contextually related to the game. "And the advertisers love that," Gibeau said, "because it doesn't feel like a punishing ad, it feels like an ad they [players] like."

Make New Friends, But Keep the Old

GET MORE INFO

Talk About ZNGA

- [See why Zynga scores a 12 on our unique 25-point Risk Rating.]
- [See how you can tell if this investment is going right — or wrong.]
- [Talk about how Zynga fits into SA here]

overall value, for instance — and add a little at a time.

KEY DATA

- **Headquarters:** San Francisco, Calif.
- **Website:** Zynga investor relations
- **Market Cap:** $4.97 billion
- **Cash/Debt:** $581.2 million / $100 million
- **Revenue (TTM):** $907.2 million
- **Earnings (TTM):** $15.5 million
- **Revenue (2015/'16/'17):** $764.7 million / $741.4 million / $861.4 million
- **Earnings (2015/'16/'17):** ($121.5 million) / ($108.2 million) / $26.6 million

Add ZNGA to Your Favorites

If the company can keep its forever franchises fresh and create new ones, Zynga is very likely to be a winner. *Zynga Poker*, for instance, brought in more revenue last year than it did four years ago, thanks in part to regular updates and refreshes. The idea is to lure new players, keep existing players engaged, and convince former players to come back again. The rollout of 5G wireless will mean new ways to distribute and play games and keep things feeling fresh. A winning concept like *FarmVille,* meanwhile, can be reworked — the company continues to make a significant amount of revenue from various versions of this title.

And then there are entirely new games. Much of Zynga's current management team came over from gaming giant **Electronic Arts** (NASDAQ: EA) in 2016, replacing the founders. (One of those founders, former CEO Mark Pincus — who named Zynga after his bulldog — is currently chairman of the board.) Before the changeover, Zynga spent huge amounts of money on R&D to develop its own titles. The company still invests heavily in new ideas — it spent 29% of revenue on internal development last year — but Gibeau has adopted a strategy of acquiring proven concepts that the company can turn into lasting franchises. Last year, Zynga entered into licensing deals to launch games based on *Harry Potter*, *Game of*

Thrones, and *Star Wars*. While the first of these games won't appear until the second half of this year (and *Star Wars* isn't expected till 2020), we're betting that the company can accelerate the return to growth that has come under Gibeau's tenure.

In fact, that's already happening. Zynga is predicting revenue of $1.15 billion this year, which would represent year-over-year growth of 27%, the company's fastest pace of expansion since 2011.

Right now, Zynga's financials may not look especially impressive, but as revenue grows quickly and the company leans more on acquired games that require less marketing investment, we think profits will skyrocket. Zynga is only marginally profitable today, with an operating margin of merely 1.7% in 2018, though that's a welcome change after six consecutive years of losses. Over time, management is targeting operating margins over 20%, which would put it closer to other gaming companies. In the meantime, we take it as another sign of progress that Zynga's free cash flow rose to $157 million last year. The stock is currently trading at 32 times that figure, which doesn't sound especially cheap, but again, we think Zynga's likelihood of continued improvement is more relevant.

Risks and When We'd Sell

Forever franchises are unlikely to really last forever. *Zynga Poker* has remained very popular for a decade, but others may not have the same staying power. And even *Zynga Poker* saw a slight decline in revenue last year. This is a highly competitive business, and companies tend to copy successful titles, which can dilute the audience over time.

Moreover, the company's recent focus on growth through M&A may mean fewer R&D and marketing expenses, but it means more debt. While Zynga has a comfortable cash reserve of $581 million, it recently took on a $100 million short-term loan. It is also amassing goodwill on its balance sheet — currently $934 million. This represents the cost of acquired companies net of their tangible assets. But if it launches lemons based on these acquisitions, it will have to write down goodwill — meaning a potentially significant hit to future earnings.

The Foolish Bottom Line

Casual games are serious business. The mega-popular game *Fortnite* famously brought Epic Games $3 billion in *profits* last year — nearly totaling the *combined* net income of Electronic Arts and **Activision Blizzard** (NASDAQ: ATVI). Zynga may never hit a home run quite like that, but it has proven it can keep turning out successful franchises with staying power and the potential for massive cash flow. As mobile devices get better — with more capabilities in augmented and virtual reality, faster streaming to tap into AI, and more — games will keep getting better. And few game makers will match the zing of Zynga.

Karl Thiel contributed to this report.

Randi Zuckerberg, a former director of market development and spokeswoman for Facebook and sister to its CEO, Mark Zuckerberg, is a member of The Motley Fool's board of directors. David Gardner owns shares of Activision Blizzard and Facebook. Tom Gardner owns shares of Facebook. The Motley Fool owns shares of Activision Blizzard and Facebook. The Motley Fool has a disclosure policy.

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