Buy Zynga

David Gardner | July 18, 2019 | Buy Recommendation

CURRENT PRICE: ZNGA $ 9.76 ↑ $ 0.32 (3.3%) [illegible]

I first recommended casual gaming leader **Zynga** (NASDAQ: ZNGA) back in April because I believed the company's turnaround had been largely overlooked by Wall Street. Investors didn't recognize that management hadn't just found a way to survive in the years since it declared independence from **Facebook** (NASDAQ: FB), but rather cleared the board for rapid growth in profitability.

Three months later, I can't claim that a whole lot has changed, yet the early signs are encouraging. The company reported first-quarter results on May 1 and raised guidance for the year on the strength of performance from its five "Forever Franchises," its term for games that top $100 million in annual bookings for five years running. Good results helped push the stock higher — it's up 16% in a few weeks, versus a 4% rise in the S&P 500.

But all of these are short-term developments. Wall Street reacted positively to a nice quarter, yet I think the company's longer trajectory remains overlooked. I believe Zynga — still trading at about half of its post-IPO peak valuation — can keep winning the game.

So I'm highlighting this opportunity once more. If you didn't buy Zynga last time around, reconsider. If you took a starter position in it, consider adding more.

ZYNGA IN 1 MINUTE

WHAT IT DOES

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

WHY YOU SHOULD BUY

- Zynga just raised guidance for 2019 on the strength of its five "Forever Franchises."
- The company continues to diversify its revenue stream and its platforms for play — including a new title on Snapchat's game platform.
- The company recently raised cash and has flexibility to make more opportunistic acquisitions.

BUYER'S GUIDE

- **Industry:** Entertainment
- **Size:** Mid Cap
- **Region:** Global
- **July 17 Price:** $6.23
- **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 overall value, for instance — and add a little at a time.

KEY DATA

Back in the Game

Why do I think Zynga's success will extend beyond the next quarter or two? Because the company's efforts at diversification over the past several years are bearing fruit, and because its growth drivers look durable.

Zynga's revenue is rising quickly — up 27% in the most recent quarter — but its bookings are growing even faster, up 64% in the same period. What does that mean? The company defines bookings as recognized revenue plus deferred revenue from virtual items or certain advertising sales. In other words, when players buy virtual items (like tokens, or virtual cash, or other in-game purchases), Zynga recognizes this revenue over the life of the item or the typical tenure of an average player. So fast-rising bookings point to continued — indeed, accelerating — future growth. The company now expects revenue of $1.2 billion for 2019, which would be an increase of 32% over 2018. And that may be a lowball estimate.

The company did report a steep loss in the first quarter thanks to higher-than-expected earnout payments it expects to make related to the acquisitions of Small Giant Games and Gram Games last year. Yet that's actually another indication of strength: Management has raised its lifetime value estimates for these companies and will thus make higher contingent payments — while reaping the benefits of new titles like *Empires & Puzzles* and *Merge Dragons*, now two of its current five Forever Franchises. The current senior management team, many members of which came over from **Electronic Arts** (NASDAQ: EA) in 2016, have deliberately focused on mergers and acquisitions instead of relying on internal development, and this is an indication that that, too, is paying off.

- **Headquarters:** San Francisco, Calif.
- **Website:** Zynga investor relations
- **Market Cap:** $5.92 billion
- **Cash/Debt:** $246.4 million / $129.2 million
- **Revenue (TTM):** $964.4 million
- **Earnings (TTM):** ($119.0 million)
- **Revenue (2016/'17/'18):** $741.4 million / $861.4 million / $907.2 million
- **Earnings (2016/'17/'18):** ($108.2 million) / $26.6 million / $15.5 million

Add ZNGA to Your Favorites

It's a smart strategy. Sinking a lot of money into game development can produce a winning concept, but casual games are typically easier to mimic than console titles. Instead, Zynga is focusing on proven winners, smart marketing, and licensing deals that give it an edge. *Game of Thrones Slots*, which went into what management considers a "soft launch" in the first quarter, is an example of a licensed brand that should give the company an edge in a very popular game category. Titles based on *Star Wars* and *Harry Potter* should be emerging over the next couple years.

Nor is that likely to be the last deal we'll see. The company issued $600 million in convertible notes (convertible to common stock at $8.31 per share) in June, giving the company more leeway for potential deals.

Fun in More Pockets

After six years of consecutive losses, it has been good to see Zynga eke out modest profits in some recent quarters. The bottom line is still nothing to brag about at this point, but the company is producing consistently positive cash flow.

With its long-term target of 20% operating margins (or better), we believe the company can produce over $400 million in operating profit three years from now. And because it will always have large non-cash amortization charges as it writes down the value of its software, we expect cash flow to be at least this strong. That's not too long to wait for a company currently valued at under 15 times that figure.

GET MORE INFO

Talk About ZNGA

Talk about how ZNGA fits into *SA* here

See why Zynga scores a 13 on our unique 25-point Risk Rating.

See how you can tell if this investment is going right — or wrong.

Zynga was once reliant on Facebook, but the company has long since made most of its revenue through app stores. It has been particularly reliant on **Apple**'s (NASDAQ: AAPL) ecosystem, but it is now making major inroads on the Android platform.

Alphabet (NASDAQ: GOOG) (NASDAQ: GOOGL) represented 39% of bookings last year, but bookings on the Android platform doubled in the first quarter versus a year earlier. Nor is the company content with that level of diversification. *Tiny Royale*, a *Fortnite*-inspired battleground game with a highly social aspect, recently launched on **Snapchat**'s (NYSE: SNAP) in-app game platform. The rollout of 5G, meanwhile, is only going to make mobile games faster, more ambitious, and easier to play. The playing field is changing more rapidly for mobile than it is for console games, and we want a piece of a leader in the space.

Risks and When We'd Sell

Mobile game sales have been growing at a double-digit pace since the launch of the original iPhone in 2007. They now represent over half of a $138 billion annual global gaming market. This business is only getting bigger, and Zynga has only a small part of it. That leaves plenty of room to grow, but it also indicates how intense competition is. All of Zynga's Forever Franchises — *Words With Friends*, *CSR Racing*, *Zynga Poker*, *Empires & Puzzles*, and *Merge Dragons* — have to contend with alternative titles pursuing essentially the same concept. Forever is a long time, and the company needs to invest in updates and marketing to keep these fresh for as long as possible. Even so, there's no guarantee any or all of them won't go into decline.

That means the company needs to also invest in developing or acquiring new games. And that can get expensive. The company spent $280 million on research and development over the past year. It also spent $560 million to acquire 80% of Small Giant (developer of *Empires & Puzzles*), as well as $250 million on Gram Games (*Merge Dragons*), not counting additional earnouts.

That could put some strain on the balance sheet. The company has mostly relied on cash and short-term borrowing to date, as well as some stock-based transactions. But the company's recent $600 million note offering shows it is willing to take on further cash obligations — or, more likely, dilution to shareholders. Right now, the company appears to be getting good value for its purchases, but growing competition could raise the cost of M&A.

The Foolish Bottom Line

FarmVille, the game that first made Zynga famous, reached its 10th anniversary in June. With over 650 million installs over the past decade, *FarmVille* proves that casual games have a huge reach and long staying power. Consider that the three top-selling console and PC games of all time — *Tetris*, *Minecraft*, and *Grand Theft Auto V* — have sold a *combined* 410 million units over their long lifetimes. Most of us spend at least some time playing games on our phones, and even if we consider them trivial time-wasters, it's still a huge business. As it evolves, we see Zynga as an emerging powerhouse that uses its scale to find and make the most of emerging titles. Wall Street still doesn't get the game they're playing.

Karl Thiel contributed to this report.

DAVID CALLED IT AGAIN: Do you agree that Zynga will beat the market over the next 3-5 years? (After voting, buy shares to invest right away or add ZNGA to your Favorites for alerts later.)

NOT SURE

NO

YES

Suzanne Frey, an executive at Alphabet, is a member of The Motley Fool's board of directors. 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 Alphabet (A shares), Alphabet (C shares), Apple, and Facebook.

Tom Gardner owns shares of Alphabet (A shares), Alphabet (C shares), and Facebook. The Motley Fool owns shares of Alphabet (A shares), Alphabet (C shares), Apple, and Facebook and has the following options: short January 2020 $155 calls on Apple, long January 2020 $150 calls on Apple, short January 2020 $155 calls on Apple, and long January 2020 $150 calls on Apple. The Motley Fool has a disclosure policy.

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