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## **Think Entertainment: Gaming**

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### **Social Games: Interview With The CEO Of Zynga**

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**Reason for Report:**

**Industry Update**

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**THINK SUMMARY:**

We had a chance to interview Mark Pincus, the CEO and Founder of Zynga, one of the leading social gaming companies, with about 20 games across seven social networks and 30 million monthly unique users. We believe that social gaming companies such as Zynga will benefit from the viral distribution, high reach, and continued growth of social networking sites. In addition, we believe that the Generation Y's comfort level with Internet and virtual worlds could drive spending on virtual goods, which could benefit online gaming companies such as Zynga that are trying to monetize users through virtual goods model.

**KEY POINTS:**

- Zynga is one of the largest and fastest-growing social gaming companies, with 20 games across seven social networks and 30 million monthly unique users.
- We believe that the viral distribution, high reach, and continued growth momentum of social networking sites provide secular tailwinds for social gaming companies such as Zynga.
- All of the company's games are free-to-play and Zynga monetizes its users through in-game advertising, virtual goods, lead generation, and application installs. Pincus believes that the application installs and virtual goods will be the biggest revenue generating opportunities for the social gaming companies.
- The company estimates the addressable market for social gaming at about \$250-750 million, assuming ARPU at about \$1-3 per year.
- The company hasn't yet seen any impact of the macro headwinds on the rate of player acquisition or playing habits, although the company is seeing some softening of ad rates.
- The company expects to grow by launching games on new social networking sites, by launching newer games, and by optimizing monetization.

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Atul Bagga, ThinkEquity LLC (AB): Can you explain your business, and why should customers and investors care about Zynga?

Mark Pincus, CEO, Zynga (MP): We are enabling consumers to have a fundamentally new gaming experience and social experience. For the first time ever, we're letting them engage in games with their real friends in their real social networks. My sisters, who had never played video games before, are now playing games with each other on their iPhones all the time. Gaming is a fundamentally social experience, not a single-player experience, and not a technology experience. We are bringing gaming back to its roots. So that's why I think Zynga and social gaming matters to end consumers. We have games that are used by 5.5 million daily active users. And we have 30 million monthly unique users across our games.

AB: How many games do you offer and also how many platforms you are working with?

MP: We have about 20 game applications that we support. And those are across seven social networks and growing. Some of these applications could be on all seven, and some could be on one or two networks. Facebook and MySpace are the biggest networks for us. Other social networks that we work with are Bebo, hi5, Friendster, Tagged, Meebo. We're now launching on Yahoo! And the iPhone.

AB: Is your growth mostly from offering new games or adding new networks, new channels?

MP: It's all the above. We have our major game properties like Poker, YoVille, Mafia Wars, and Vampires. We are constantly working on new game mechanics and things to drive better retention. So, we get incremental growth on those games within our existing networks. And then we get growth through new networks. We are targeting to launch a couple of major new games a year.

AB: Can you explain your business model to us?

MP: Our model is free games offered on top of social networks. They're supported by various revenue streams, in-game ads, virtual item sales or what we call user pay, and lead gen that is offers from sponsors like Blockbuster, or auto insurance or credit cards.

AB: What is the current mix of revenue between these three revenue streams? And over the next couple years, where do you see the revenue mix heading?

MP: Currently, the revenue mix is evenly distributed in all three categories. I see it probably growing somewhere within the same range. And that is because about 90-98% of users play for free and never pay for anything, or even execute an offer. Those users are monetized through ads. We also monetize this group through another way that we invented, that is through application install or CPI model. Then, a couple percent to 10% of users will do the lead gen. And then a very small percentage, anywhere from 0.5% to 2% of users, will spend real money and buy virtual items.

AB: Are there any category or genre of games where you see more of virtual items sales versus other games?

MP: We think that there's always going to be a direct correlation between user engagement and user pay. For us, purely casual games have not been a high priority, because we see them driving a lot of reach but not a lot of engagement and revenue.

AB: Do you sell ads directly or do you partner with some ad networks?

MP: We do direct sales ourselves, and we also slot in networks. We take RockYou and Social Media ads. Sometimes we take ads directly from the host network, like MySpace. On direct sales, we sell CPC and CPI ads. On the CPA front, we slot Super Awards and Offerpal. We're also doing some tests with companies like DoubleFusion.

AB: How do the rates compare for in-game ads versus other display ads or video ads?

MP: Rates vary a lot with volume. We do a very large number of page views. By last count, we were over six billion page views a month. On the CPM front, we get 15 to 20 cents CPMs. On the CPI front, depending on volumes, we sell installs anywhere from 50 cents to \$1. We also will sell on a CPC, and that can be anywhere from 10 to 25 cents a click.

AB: Can you share some thoughts on how the in-game advertising compares versus other media?

MP: I believe that we're on the verge of two new business models on the Internet. And it's amazing to me that they're both happening right now, because we haven't had a new business model on the Internet in eight years since Google search. One of them is a new way of Web marketing, which is a scalable way for smart Web marketers to acquire customers. There are a few of us that are in the business of using that channel, but within a couple years, it's going to become an industry unto itself, and become a normal marketing channel just like SEM and SEO. That's the idea of CPI. It is the idea of using social networks and the open APIs as a customer acquisition channel. Here's the simple economics. You can get on our

network tomorrow, and we'll sell you 100,000 installs for 50 cents an install. So, for \$50,000 we'll deliver to you 100,000 installs. An install is a Web instantiation. It's getting a somewhat permanent navigational instantiation of your application, right on a user's inbound and outbound Web top. They're inbound, so you're now a part of their app navigation on this new portal, be it Facebook, MySpace or Yahoo!. And outbound, whether it's their profile, their news feeds, notifications, whatever. Now, if you went with traditional online marketing, with the same \$50,000, you could buy about 100,000 clicks on Google. And about 10% of those clicks will register with you, so you get an ongoing ability to e-mail about 10,000 people. So we can give you ten times the number of marketing impressions with app install than you will get with Google click. It's a new marketing channel that I think will drive down the cost of customer acquisition in a lot of key e-commerce areas by 80%. The second is a fundamentally new business model on the Internet: the user pay Internet, i.e., users paying for virtual goods. I'm a firm believer in this new macro of the user-pay Internet. And I believe that user pay and CPI are what are going to be the two biggest revenue opportunities over the next five years for social gaming.

AB: What is the typical ROI that your advertiser clients can get from these applications installs?

MP: We don't know the ROI. We know the Investment, but we don't know the Return that advertisers get. We're not in the business of going out and selling these installs. There are companies like SocialMedia, RockYou, Slide, and Buddy Media. They're all out selling these on a direct sales basis in a big way. I can tell you that we eat our own dog food, and we are the biggest customer of our install network.

AB: How big do you think is the addressable market?

MP: Let's say that there'll be somewhere around a billion people that you can access through open portals and social networks over the next three to five years. And let's say that about quarter of this population will be engaging in games, and there may be about 250 million people involved in social gaming. That is the potential market. Now the big question is monetization. I think it will be all over the map. I'd say that those 250 million people could be monetized anywhere from \$1 to \$3 per user per year. So, it's reasonable to say that this new market of social gaming could be worth \$250 to \$750 million in revenues in 2012.

AB: Who are your competitions in today's environment?

MP: It's really other startups; its companies like SGN, Playfish, sometimes Slide and RockYou, and a lot of little independent guys, like one guy who has a couple of games on Facebook called Lil Green Patch and Lil Blue Cove. There are some VC backed companies like Serious Business. And in one year, I am sure that there will be more startups that you and I have never heard of.

AB: What do you think are the barriers for someone like Activision or Electronic Arts to get into social gaming?

MP: This is a new kind of gaming business, and it's not build and publish; it's build and serve and then have recursive loops around tweaking and serving. So this business feels more like eBay, or Amazon, or Google. It's an always-on business, where you have to have massively scalable backend. And you also have to have people watching servers all the time. The watching part isn't just about data centers and people making sure your game is up, but it's about highly skilled people who are watching your leading indicating metrics all the time. To see whether your virality, retention, engagement, and revenues are on track for; you're constantly turning dials. Then the game rules change about once a month; you either have a new social network turned on, or a social network changes their UI, or your user navigation, or the rules around virility or whatever. They turn one knob and you have 50 people or more running around. So I don't think anything stops EA and Activision from getting into this. But first, I don't think there is enough money in it for them to take carry out. Even if they own the entire market today it's not a right fit for their business model. And secondly, it's the wrong business for them right now, because it requires a very large investment and has very little payoff today. So for public companies that are focused on their earnings in the next four quarters, it doesn't look like a great bet. And, by the way, they need a totally different DNA of people. I think in a couple of years when this is all is sorted out, and if this grows into a large market, those companies will all be in this business. It's just more likely that they will sit back and wait, and they will acquire somebody and have a new division of their company, rather than be in the trenches, battling it out with startups.

AB: What is your secret sauce, or what is your differentiation that is difficult for others who replicate?

MP: We're trying to have the most scalable approach to the market. We are about 200 people in the company. We invest heavily in metrics. We've learned and watched companies like Slide and RockYou, who have been the best at being metric driven in measuring. We have recruited heavily from the game industry. We brought in people who understand real game development, not just kind of "poke your friends." And then, we have people who have deep understanding of social networks and Web marketing. We watch a lot of things; we test a lot of things. And our goal has been to be the largest in social gaming.

AB: How is the current economic slowdown impacting your business?

MP: It is hard to tell, but I think that across the board, all categories have seen the pricing soften or go down by about 10-15%. But so far, we have not seen any change in rate of player acquisition or players' playing habits or time spent.

AB: What are your initiatives over the next six months to one year that we should be paying attention to?

MP: We recently started offering Live Poker on the iPhone and are the only company to offer a live poker game on the iPhone. We saw awesome uptick with no marketing. We have had 1.2 million downloads and about 120K daily active users. We are in process of launching on Yahoo! and iGoogle.

AB: What do you see as the biggest challenge for Zynga over the next couple of years?

MP: We will continue to launch great new social games and grow them. We're in a great position. Our challenge is to continue to execute and keep our momentum.

AB: Can you give us some sense on how big Zynga is?

MP: We have 5.5 million daily active users, north of 6 billion page views, and about 200 employees. We are cash-flow breakeven.

AB: When you look out three years from now, where do you see Zynga? Is Zynga is a public company, a stand-alone independent company, or is it a part of any other bigger platform?

MP: It is hard to say. We are very focused on the business and hope that Zynga will be an independent, profitable company in the social gaming space.

**COMPANIES MENTIONED IN THIS REPORT:**

Company	Exchange	Symbol	Price	Rating	Price Target
Amazon.com, Inc.	NASDAQ	AMZN	\$61.71	Buy	\$70.00
Google, Inc.	NASDAQ	GOOG	\$330.06	SoF	\$300.00
Yahoo!	NASDAQ	YHOO	\$11.97	Acc	\$13.00

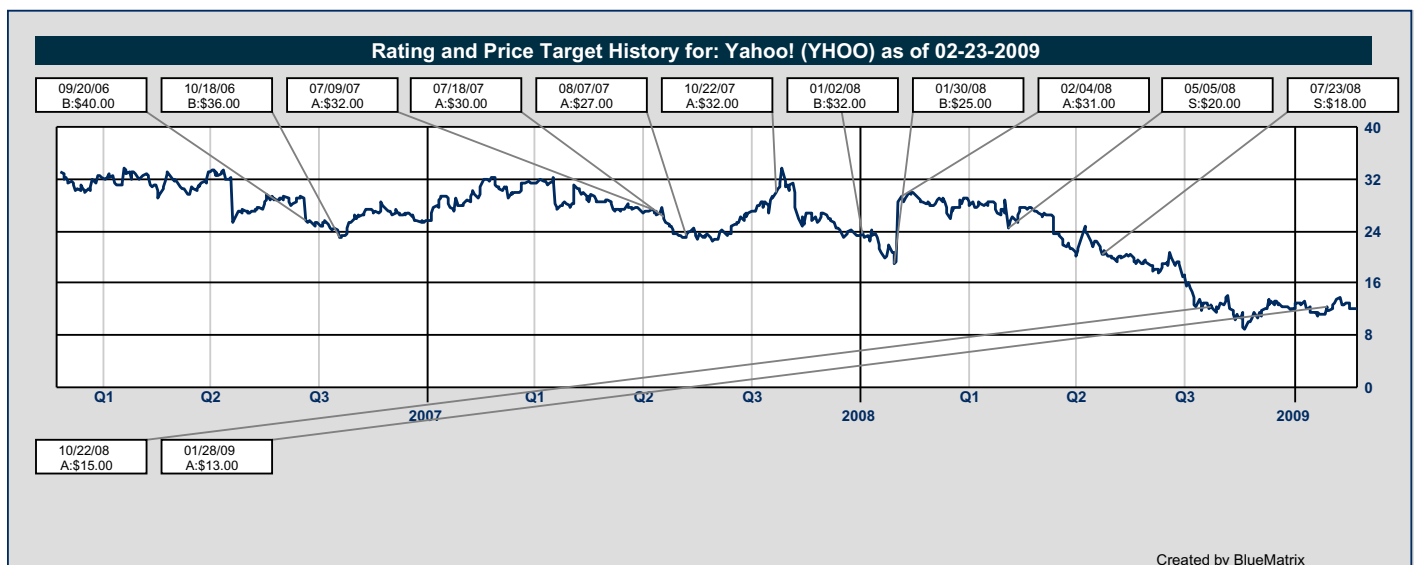
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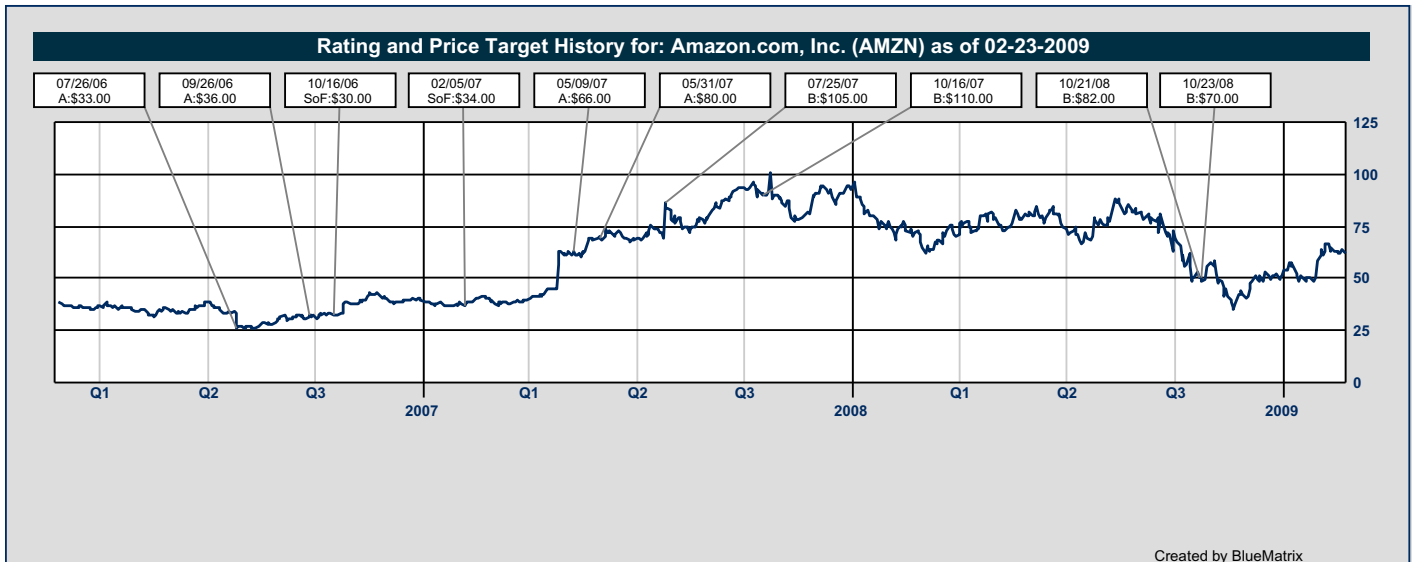
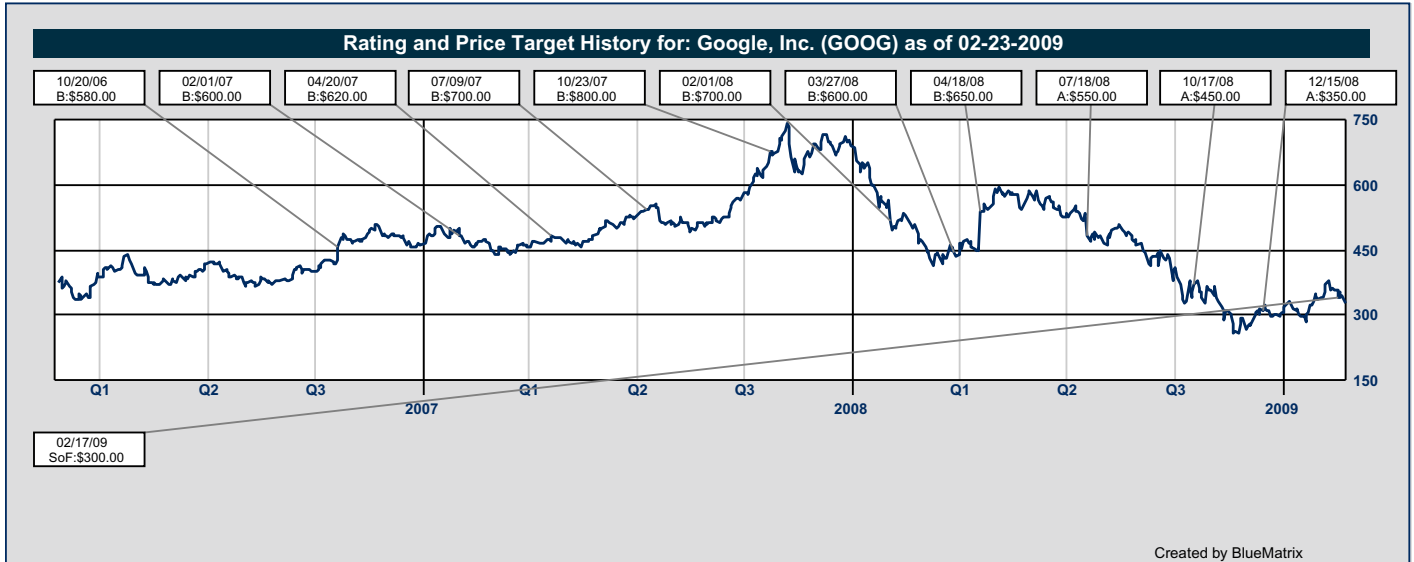
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<b>Distribution of Ratings, Firmwide</b>				
<b>ThinkEquity LLC</b>				
<b>Rating</b>	<b>Count</b>	<b>Percent</b>	<b>IB Serv./Past 12 Mos.</b>	
			<b>Count</b>	<b>Percent</b>
<b>BUY [B]</b>	<b>114</b>	<b>53.00</b>	<b>18</b>	<b>15.79</b>
<b>HOLD [Acc]</b>	<b>71</b>	<b>33.00</b>	<b>4</b>	<b>5.63</b>
<b>SELL [S/SoF]</b>	<b>30</b>	<b>14.00</b>	<b>1</b>	<b>3.33</b>

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