

Exhibit 18



The Business of Social Media

Mobile, social media and digital content opportunities

[Home](#) / [General Social Games Business](#) / A look inside Zynga's numbers

A look inside Zynga's numbers

July 31, 2012— [12 Comments](#)

Originally, I was not going to post about Zynga's earnings report, which was released Wednesday evening. I am not a stock analyst and I did not feel I brought much to the party. However, the announcement caused so much conversation both from companies in the social gaming space and pretty much everyone else, that I felt remiss if I did not add my analysis.



What the numbers really say

The most important numbers are that Zynga generated \$302 million in bookings (an alternative measurement of revenue that is more accurate for social game companies other than [GAAP](#) revenue) and a loss of \$22.8 million for the quarter. For the year, Zynga is projecting revenue of about \$1.2 billion and a profit (adjusted [EBITDA](#)) of between \$180 million and \$250 million.

These numbers are all below analysts' and investors' expectations, and prompted Zynga's stock to drop almost 40 percent. If you read the press or blogs (or talked to people at Casual Connect), you

would think this 40 percent drop meant either the end of the social gaming industry, the end of Facebook, or at least the end of Zynga. What it reflects, however, were the huge expectations for Zynga leading up to its IPO. Zynga would have had to continue its miraculous growth to justify its initial public valuation, and quite simply, it did not. That does not make Zynga a bad company or social gaming a dying industry; it just means everyone must face reality.

Comparison with Glu

An interesting juxtaposition was Zynga's fortunes compared with Glu Mobile's earnings report last week. Glu beat analysts' estimates on both revenue and profits. Glu reported revenue for the quarter of \$21.6 million, with a \$6 million loss for the quarter. Because these numbers exceeded expectations, Glu's shares jumped and analysts spoke as if it showed that they were a hotter company than Zynga. The bottom line is Zynga generated almost 14 times the revenue of Glu (almost \$280 million more) and has multiple Facebook games that generate more revenue individually than Glu does as a company.

I do not wish to imply that I am beating up on Glu; I have some good friends there (hopefully still after this post) and they are on the right track. I just feel it is quite important to highlight and compare the absolute numbers that both these companies are generating, because many people are creating a narrative that does not fit the facts and then making decisions based on this narrative. Since Glu is one of the few publicly traded mobile game companies that generates most of its revenue outside Asia, it is a good starting point to gather data to compare with Zynga. Glu was in the mobile space before Zynga even existed. Although it was slow to move to free-to-play, it had a huge head start on most gaming companies in the mobile social gaming sphere. If mobile was truly the money machine so many would like us to believe and Facebook was a dead platform, shouldn't Glu be closer to Zynga in revenue rather than 1/14th its size? From these numbers, we can probably extrapolate the revenue of other mobile-only social gaming companies. And those numbers are almost certainly not close to Zynga's (again, excluding the Asian social mobile companies).

So why did Zynga miss its numbers?

One of the most interesting elements of the earnings call was the reasons that Zynga missed its numbers. According to Mark Pincus, "[Zynga] saw declines in engagement and bookings for our Web games due in part to changes Facebook made to their platform." Zynga also blamed the lower earnings on delayed product launches and reduced expectations for *Draw Something*.

The above is the "official" line. In my analysis there are three **real** reasons that Zynga underperformed

1. **We exist in a hit-driven industry.** I previously wrote that at best 25 percent of social games break even or make a profit. Zynga is not immune to these baseline rates. As much as social and mobile game companies have tried to convince VCs and investors that we no longer live in a hit-driven world, the reality is we do and Zynga does (as does EA, Disney, etc.). Thus, every launch has a 75 percent chance of failure and that is what Zynga experienced last quarter. They did not lose their magic; they suffered regression to the mean. If they had one hit last quarter (or have one this quarter), the narrative will be entirely different, even though the underlying business remains unchanged.
2. **Fast following is not as easy as it is used to be.** There was a day when Zynga could identify a successful game on Facebook, polish the underlying mechanic and theme, and blow up their product with overwhelming marketing. The market has evolved to the point that this strategy no longer works. While Zynga was able to overwhelm SocialApps (*MyFarm*) with the launch of *Farmville*, *Mob Wars*' creator David Maestri with *Mafia Wars* and Playdom (*Social City*) with *Cityville*, using this model, the new wave of competitors are not as easy picking. Playdom is now owned by Disney, so Zynga's attempt to overwhelm *Gardens of Time* was met dollar for dollar.

The launch of *Ville* was disappointing because Zynga was now competing for players with EA, who could drive as much traffic as it wanted to *The Sims Social*. Even NimbleBit (*Tiny Tower*) was able to stave off *Dream Heights* because in the current social gaming environment, it could acquire enough users that there were few left for Zynga. This last point is particularly relevant, as once a game gains broad popularity (e.g., *The Sims Social* or *Tiny Tower*) it is virtually impossible to win over that audience unless you make a revolutionary improvement to the experience. Once a player has invested time and money into a game, they are not going to switch to another game (and lose that investment) just because the interface is a little cleaner or graphics sharper. I witnessed the same thing when launching international versions of popular Facebook games as a separate product. Even though people preferred to play in their native language, it was not worth it to switch to the localized version for most players and lose the progress they had made in the English version (in many cases dooming the branched versions). The same dynamic now limits Zynga's ability to win over existing players from popular competing social games by introducing a mildly better version (and because of marketing, there are very few users who have not been exposed to the original).

3. **When you burn the furniture, you have nothing to sit on.** I have worked at several ventures that were nearing an exit event and in all my experiences extraordinary efforts were made to move revenue and profits into the period that would most impact valuation, even if it hurt future business. In one case, I was asked to "burn the furniture" so more revenue could be recognized in the month we were hoping to close a deal, even at the expense of negatively impacting revenue for quarters to come. Although I have no direct knowledge of how Zynga operated just before its IPO, given the mentality I have seen frequently, it is not a big stretch to think a lot of furniture was burned pre-IPO that now has to be replaced (and thus dragging on revenue and profitability).

What the numbers do not mean

First, mobile has not replaced Facebook web as the only social platform. Although Zynga listed Facebook as its number one problem, its mobile performance has been no better (let's not forget that *Words with Friends*, *Draw Something* and *Dream Tower* were first and foremost mobile offerings). Moreover, as I pointed out by comparing Zynga's performance with Glu's, Zynga is still generating more from individual Facebook games than Glu is generating as a company, despite Glu's focus and experience in the mobile space. I am not saying mobile social is not a great opportunity or potentially the future of our industry (or a key part of it); but we must look at the facts before writing off the Facebook platform.

Second, Zynga is far from dead. I do not have an opinion on Zynga's valuation, but just looking at the numbers I recapped above (\$300+ million in bookings for the quarter, \$1.2 billion in revenue projected for the year and an expected annual profit of over \$180 million) shows that Zynga is one of the most important game companies in the world and clearly the leading social game company outside of Asia.

Shut up Zynga haters

The main reason for this post is to counter some of the incredibly stupid comments I have seen in the last few days both from inside and outside the industry.

The glee that our colleagues in the social game space are taking at Zynga's difficulties are not logical and will hurt them as much as anyone. Like it or not, outside of our little world, social gaming and Zynga are virtually synonymous. Thus, if people feel Zynga is not a good company, they feel we are not in a good industry. That leads to fewer investment dollars and fewer opportunities for an exit (either through an acquisition or public offering). If they are already part of a larger public company, it means their importance to the parent company is diminished, because the multiple applied to their revenue is

less. With lower importance, comes less investment (e.g., fewer resources and potentially less staff). It is cute to laugh at Zynga until you hear that your group is being closed down because social gaming is no longer attractive.

Even more annoying are the sometimes incredibly ignorant comments from industry analysts who really do not understand our industry. These type of comments have always been a problem in the game space, as we have a very idiosyncratic industry that is difficult to understand from the outside. Add to that problem that because the gaming space is small in absolute terms, we typically do not receive attention from the “AAA” analysts.

The most absurd comment I saw in this round of commentary about Zynga was from Michael Gartenberg, who said, “At the end of the day, though, virtual goods might not be a viable business strategy. People eventually stop spending money in virtual goods and want to spend that money on real goods.” Yet Gartenberg provided no evidence that this is the case (keep in mind that Zynga’s revenue was effectively flat), other than apparently wishful thinking on his part. The same week that Zynga missed its numbers, Starbucks also significantly missed theirs (and also suffered a big hit on its stock). I am surprised that Gartenberg did not comment on this situation that “At the end of the day, though, premium coffee might not be a viable business strategy. People eventually stop spending \$4 on coffee and want to spend only \$0.50 on real coffee.”

Conclusion

I do not know if Zynga’s stock is overpriced or underpriced, but I wrote this post in the hopes that people can look objectively at the company and industry rather than get sucked into a highly inaccurate narrative.

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In General Social Games Business Glu Mobile, Michael Gartenberg, mobile social, social gaming, zynga, zynga valuation



12 responses to *A look inside Zynga's numbers*



Rob Ollett July 31, 2012 at 1:53 PM

Hi Lloyd, thanks for putting some perspective around this issue. I agree Zynga is imploding or failing miserably. But I do feel they could grow quicker by diversifying their content. For example I really liked Empires and Allies and I hoped this was the first in a more mid-core strategy, but nothing new has launched that continued my interest in Zynga's games. Now, some could say I'm not Zynga's main target audience, by not being female and over 40, but I still manage to enjoy mass market casual titles on iOS such as Ski Safari (which is totally awesome) and Fruit Ninja etc. I just think Mr Pincus has focused his sights on gambling and missed a whole chunk of players like myself that use Facebook frequently but rarely find quality games content there. Anyway, just my two cents worth.

[Reply](#)



Lloyd Melnick July 31, 2012 at 1:56 PM

I definitely agree but it leaves more opportunities for you and I.

[Reply](#)



dconnors July 31, 2012 at 2:30 PM

Nicely done Lloyd very good points. Maybe you should be a stock analyst. I will say this Hype has two sides

[Reply](#)



Arnold Hendrick July 31, 2012 at 4:09 PM

The best view I've seen on Zynga's current troubles. The points about furniture burning and fast-following being problematic are especially well-taken. I've seen both of the above at game companies in the past.

I found Gartenberg's comment hilarious. Perhaps it will frighten away the ignorant so that everyone who knows better enjoys a slightly clearer playing field.

Sooner or later Zynga will stumble onto a "successful 25%" title that becomes a big hit. Its stock will rise. Journalists and analysts will scream about some important new direction in the game industry. That crowd prefers to portray "news" as dramatic and surprising change-event. They gain little by saying, "Oh, it's not that earth-shaking. This latest information fits into a larger pattern..."

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Jan Beckers July 31, 2012 at 4:36 PM

Great post Lloyd! The "burned furniture" argument also explains why eg Warren Buffet systematically avoids to buy during/close to an IPO event.

[Reply](#)



Lloyd Melnick July 31, 2012 at 4:46 PM

I could see that. I never really understood it until I was part of it but it is just crazy.

[Reply](#)



jodee vallone July 31, 2012 at 6:10 PM

Great comments on an ever evolving industry

[Reply](#)



sam walters August 1, 2012 at 8:34 AM

Much appreciated article on the Zynga story. Could you comment on the US and International gambling opportunity? The competition in that space appears to be fierce, with many competitors just waiting to enter. Thank you.

[Reply](#)



Lloyd Melnick August 1, 2012 at 9:49 AM

I do not have direct experience in the gambling space but expect it will not be the panacea some on Wall Street think it will be. First, as you said, it is extremely competitive. You have all the British and Continental gaming companies who really understand the space and consumer behavior. In addition, you have the gambling giants like Caesars who are willing to make huge investments, have brand recognition with target players and also have very advanced analytics for this type of gaming. Given the stakes (pardon the pun), I think it will be a more competitive, not less, competitive space. Second, it will take awhile before it is legalized broadly in the US. Nothing happens quickly anymore politically and it is still a very charged issue. My guess is 2-4 years before any significant liberalization.

[Reply](#)

Greg Mitchell August 1, 2012 at 12:28 PM



Very balanced analysis. You didn't take the negatives out of the context of the broader social gaming industry.

[Reply](#)



Jeff Wells *August 1, 2012 at 7:23 PM*

I have been involved in a number of industries and I agree that the ramp up to going public is a locker room hype mentality. Also though, once you are public, the quarterly objectives change business objectives that are better made with long term objectives that will really build a business.

I think all companies need to focus now on more retentive games and finding better ways to monetize them. Check out "Family Village" on Facebook. Its a game that has a long-term socially meaningful game play expectation and monetizes in a non-traditional way by helping the game player collect and store family documents from the web having to do with their family tree.

Again, a good article in content and well written.

[Reply](#)

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About Lloyd



Lloyd Melnick

Chief Growth Officer at Spooky Cool Labs

Game industry veteran. Co-founded Merscom, where I led all marketing, business development and growth efforts. Then initiated the sale of Merscom to Playdom. At Playdom, and subsequently Disney, led International Publishing team responsible for Europe, Latin America, Russia and India. Built international business from scratch to over 25 percent of company's revenue and traffic. Currently lead the growth team at Spooky Cool Labs, leading the team responsible for user acquisition, marketing, analytics and monetization.



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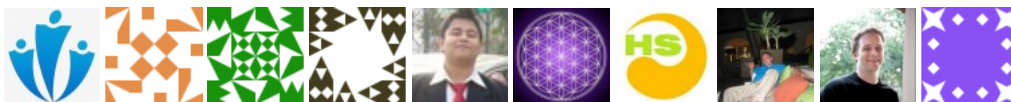
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HBR Blog

The Graduation Advice We Wish We'd Been Given

In this time of hope and decorative mortarboards, we reached out to some of our favorite writers, asking them: What do graduates really need to know about the world of work? Their answers are below. Heidi Grant Halvorson Associate director for the Motivation Science Center at the Columbia University Business School and author of *Nine Things Successful People* [...]

Yahoo, Tumblr, and the Loyalty Factor

As Yahoo goes through with its acquisition of Tumblr, CEO Marissa Mayer may have a user rebellion on her hands. The early reaction from the Tumblr community is not encouraging — blogs lit up with memes of crying babies and apocalyptic rants upon the announcement of the news. The uproar was bolstered by stories critical of Yahoo's earlier acquisitions, a [...]

Techcrunch

Yahoo Drops Flickr Pro To Compete With Facebook, Still Offers Two Paid Tiers For Ad Haters And Power Users

The bookend to Yahoo's Big News Day -- a major refresh of its photo sharing site Flickr -- will see the company drop is Flickr Pro pricing tiers as part of a bid to compete better with Facebook/Instagram and the rest of the crowded market in the online photo space. But it is not getting rid of paid tiers altogether: it's keeping an ad-free tier, ca [...]

Yahoo's Unwatchable Live Stream Proves Its Next Acquisition Should Be A Proper Video Platform

It's easy to forget that Yahoo has had a long on-again-off-again love affair with online video. Remember Broadcast.com, which kicked off the Mark Cuban Era? But you might not remember that, because other online video platforms long ago left Yahoo in the proverbial dust. Today, as Yahoo streamed its Flickr product and Tumblr acquisition announcements, we [...]

MIT Sloan Management Review Blog

Big Data and Big Change Management: A Path Forward

MIT Sloan School of Management recently held a two-day executive education course, Big Data: Making Complex Things Simpler, designed to provide executives with both an overview of big data and a few techniques to harness some of the elusive power of that data. During the event, MIT researchers Alex "Sandy" Pentland and Erik Brynjolfsson talked [...]

Educating Executives Online in Four Dimensions

I am the proud recipient of an MIT Sloan Executive Education Course certification. Or should I say, my avatar is. MIT Sloan's Big Data 4Dx executive education course, held simultaneously in Cambridge and in the virtual world this April, was the first ever to use a gaming interface. Think Second Life for the professional set. [...]

Fred Wilson blog

Success Has A Thousand Fathers

Back in the early days of AVC, I did a thing called VC Cliche Of The Week. There was an RSS feed of all of them powered by Delicious, but it is broken and most likely can't be fixed. You...

Congratulations Indiana

We talk a lot of NBA basketball in the comments but I don't post about it. This blog is supposed to be about startups and tech, for the most part. But the Knicks lost last night in Indiana and my...

Mark Suster blog

Why We Need to Elect @EricGarcetti on Tues as Next Mayor of Los Angeles

On Tuesday Los Angeles will elect a new mayor. And while Eric Garcetti is leading in the polls by 7%, according to recent articles a victory is not certain. LA needs Garcetti. He would be the first tech mayor of...
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Should You Consider Replacing Yourself as CEO?

My internal compass has always steered me strongly toward the belief that founders who can scale with their startup companies are better to back than founders who eventually need to hire a CEO. I have talked about this publicly a...Read more ›

Nate Silver's Blog

New Audit Allegations Show Flawed Statistical Thinking

Some conservatives are alleging that the I.R.S. targeted not just conservative groups, but also individual conservative taxpayers. But a handful of anecdotal data points are not worth very much in a country of 300 million people.

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