

CASE 19

ZYNGA*

Zynga, located in San Francisco, California, has become a dominant player in the online gaming field, almost entirely through the use of social media platforms. The company name was established by the CEO, Mark Pincus, to pay tribute to his late beloved pet bulldog named Zinga. Although this seems whimsical, Zynga was actually quite a powerful company. To exemplify Zynga's prominence, Facebook, which in 2012 had revenues exceeding \$3.7 billion, was reported to have earned roughly 12 percent of that revenue from the operations of Zynga's virtual merchandise sales.¹

No other direct competitor is close to this revenue lead. Zynga's collection of games continues to increase, with more and more success stories emerging. Being a relatively new company to the market, their quick success is astonishing, something that not many others have been able to mimic. However, Zynga's impressive financials may be at risk because of what may be considered questionable decision making. Many of Zynga's competitors, and even some partners, are displeased with their actions and have begun to show it in the form of litigation. Agincourt, a plaintiff of a recent lawsuit brought against Zynga, was quoted as saying, "Zynga's remarkable growth has not been driven by its own ingenuity. Rather it has been widely reported that Zynga's business model is to copy creative ideas and game designs from other game developers and then use its market power to bulldoze the games' originators."² If these lawsuits and other ethical issues continue to arise for Zynga as often as they have been, Zynga's powerful bulldog may start looking more like a poodle.

The Product

With a newfound abundance of software developers, the ability to create and distribute these games is increasing by the day, and the demand to play them is equally high. However, while many people find these games fun, and better yet therapeutic, others can't understand the hype. The best way to illuminate the sudden infatuation is to observe it as a relaxation method. In the movies, often you see large executive offices with putting greens, dart boards, or even a bar full of alcoholic beverages. These all mean to serve the same purpose: to relieve stress during a hard day's work. We've all been there and all look for a way to cope. However, few of us have the opportunity to use such things as

putting greens to unwind at the workplace. And even if we did, how long could we really afford to partake in such an activity before being pulled back to our desks? This is one of the many purposes that these virtual games fulfill. No need to leave your desk. No need to make others around you aware of your relaxation periods. Better yet, no need to separate the task of relaxation from sitting at your computer while you work. The ability to log onto these games from the very same screen and "relax" here and there as the day goes by makes it all the more enticing. This, of course, is just one of many uses for the games. Others play it after work or at the end of a long day. With the takeover of smartphones, people of all ages can play these games on the go throughout the day. Sitting on the bus, in the waiting room of a doctor's office, or at the DMV, it has never been easier to interact through gameplay that is readily available with the click of a button.

Market Size

Compared to other game developers with games present on the Facebook platform, Zynga is a dominant force. It ranks first in market share at about 39 percent and first in revenue generation at over \$500 million. It has 38 percent of the daily Facebook game players, and about 240 million monthly users, roughly 18 percent of all Facebook's users as of 2012 (see Exhibits 1 and 2). Zynga's nearest competitor, EA Playfish, recorded just an estimated \$90 million in revenue, or 6.5 percent of the market (as of 2010).³ Zynga has gained almost all of its following through Facebook and its users, and this has led to a substantial portion of Zynga's profits.

Zynga's virtual games give the opportunity for constant build-up and improvements, offering the user virtual goods and services to increase their gaming experience. These items can be purchased using a credit card and are often needed to accomplish fast progressions in the games. These goods are advertised throughout the games and entice you by offering price cuts for larger purchases. On top of its lucrative business model selling virtual goods and advertisements, Zynga also recently raised approximately \$1 billion in capital, during its initial public offering when it began trading on NASDAQ in December 2011 (see Exhibits 3 and 4).

Zynga's virtual games can be played both remotely and through social media platforms, most commonly Facebook. As of February 2012, Zynga's games had over 240 million monthly users on Facebook.⁴ Five of Zynga's games, *FarmVille*, *CityVille*, *Empire and Allies*, *CastleVille*, and *Texas HoldEm Poker*, continue to be some of

*This case was developed by graduate student Eric S. Engelson and Professor Alan B. Eisner, Pace University. Material has been drawn from published sources to be used for class discussion. Copyright © 2013 Alan B. Eisner.

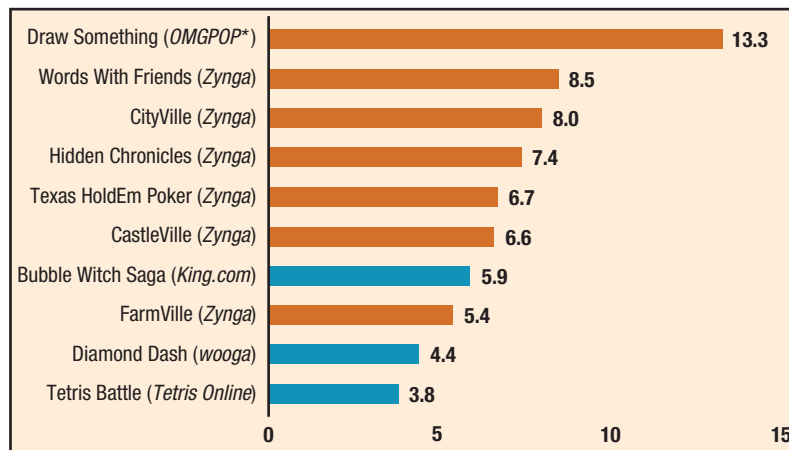
EXHIBIT 1 Virtual Gaming Revenue and Market Share

2010 Rank	Company	2010 Market Performance*	Market Share
1	Zynga	\$544	39.1%
2	EA Playfish	\$90	6.5%
3	Disney Playdom	\$77	5.5%
4	Crowdstar	\$59	4.2%
5	RockYou	\$36	2.6%

*Market performance figures in millions of dollars.

Source: assets.bizjournals.com/cms_media/seattle/zyngamarketsharechartblog.jpg?site=techflash.com.

EXHIBIT 2 Daily Users of Facebook Gaming, 2012



Source: www.gamesindustryblog.com/2012/03/zynga-is-top-dog-in-the-facebook-gaming-market/.

EXHIBIT 3

Zynga Income Statements



Go to library tab in Connect to access Case Financials.

	A	B	C	D
1	Zynga Income Statements			
2		Year Ended		
3	Non-GAAP Results	2012	2011	2010
4	Bookings	\$1,147,627	\$1,155,509	\$838,896
5	Adjusted EBITDA	\$213,233	\$303,274	\$392,738
6	Non-GAAP net income	\$58,178	\$182,483	\$238,900
7	Non-GAAP earnings per share	\$0.07	\$0.24	\$0.38
8	GAAP Results			
9	Revenue	\$1,281,267	\$1,140,100	\$597,459
10	Net income (loss)	(\$209,448)	(\$404,316)	\$90,595
11	Diluted net income (loss) per share	(\$0.28)	(\$1.40)	\$0.11

the most popular games on Facebook. *CityVille* had over 54 million active monthly users in February 2012.⁵ On July 1, 2011, Zynga filed with the SEC with intentions of raising up to \$1 billion in its IPO, and began trading on NASDAQ December 16, 2011.⁶

Of course, Zynga is not the only virtual gaming company striving for this degree of success. In fact, there are many others, in what currently seems to be one of the fastest growing industries. The capability to create these

games is widespread. Creativity and innovation are the grounds on which competing companies challenge each other. Consequently, when all competitors are after the same audience, you can be certain that the industry is prone to a significant amount of head-butting rivalry.

Background of Competitors

RockYou was founded in 2005 by Lance Tokuda and Jia Shen. Their first product was a slide-show service, crafted

EXHIBIT 4

Zynga Balance Sheets



Go to library tab in
Connect to access
Case Financials.

	A	B	C
1	Zynga Balance Sheets		
2	Zynga Inc. Consolidated Balance Sheets (in thousands, unaudited)		
3		December 31, 2012	December 31, 2011
4	Assets		
5	Current assets:		
6	Cash and cash equivalents	\$ 385,949	\$1,582,343
7	Marketable securities	898,821	225,165
8	Accounts receivable	106,327	135,633
9	Income tax receivable	5,607	18,583
10	Deferred tax assets	30,122	23,515
11	Restricted cash	28,152	3,846
12	Other current assets	29,392	34,824
13	Total current assets	1,484,370	2,023,909
14			
15	Long-term marketable securities	367,543	110,098
16	Goodwill	208,955	91,765
17	Other intangible assets, net	33,663	32,112
18	Property and equipment, net	466,074	246,740
19	Restricted cash	—	4,082
20	Other long-term assets	15,715	7,940
21	Total assets	\$ 2,576,320	\$ 2,516,646
22			
23	Liabilities and stockholders' equity		
24	Current liabilities:		
25	Accounts payable	\$ 23,298	\$ 44,020
26	Other current liabilities	146,883	167,271
27	Deferred revenue	338,964	457,394
28	Total current liabilities	509,145	668,685
29			
30	Long-term debt	100,000	—
31	Deferred revenue	8,041	23,251
32	Deferred tax liabilities	24,584	13,950
33	Other non-current liabilities	109,047	61,221
34	Total liabilities	750,817	767,107
35			
36	Stockholders' equity:		
37	Common stock and additional paid-in capital	2,725,605	2,426,168
38	Treasury stock	(295,113)	(282,897)
39	Accumulated other comprehensive income (loss)	(1,447)	362
40	Accumulated deficit	(603,542)	(394,094)
41	Total stockholders' equity	1,825,503	1,749,539
42	Total liabilities and stockholders' equity	\$ 2,576,320	\$ 2,516,646

to work as an application widget. In 2007 RockYou was one of the companies invited by Facebook to participate in the F8 event, in which Facebook announced the start of an open platform that would allow third parties to develop and run their own applications on Facebook. RockYou then shifted toward producing more in-depth social application games, such as *Toyland*, *Zoo World*, *Hero World*, and *MyCasino*. Its most played game, *Zoo World*, is a free social media application where users try to build the best zoo they can. In October 2010, the company underwent sizable layoffs, but continued to work on new and improved games.⁷

GameHouse is a developer, publisher, and distributor of casual games based in Seattle, Washington. In 2004, GameHouse was acquired by RealNetworks for \$14.6 million

cash and about 3.3 million shares of RNWK common stock, which had an estimated worth of \$21 million at the time.⁸ Prior to this acquisition, GameHouse generated their impressive amount of revenue through the sale of games on their own website, www.gamehouse.com, along with third-party affiliates and other distributors. In November 2009 GameHouse and RealArcade merged their websites into one portal in an effort to create one massive distribution center. RealArcade delivers their games on a downloadable demo basis with a 60-minute trial time for most games. When the trial expires, the user must purchase the full version to continue playing. Users also have the option of purchasing a membership package for a monthly fee. As of November 2009 GameHouse began offering the full version of many of its games, supported by the sale of in-game advertising.⁹

EA Playfish, a subsidiary of Electronic Arts, is a developer of social network games that are free to play. *Who Has the Biggest Brain?* was the company's first success and the gateway into their ability to raise funding. The company, like many of its competitors, generates revenue by selling virtual goods inside its games. On November 9, 2009, Electronic Arts acquired Playfish for US\$400 million. As of January 2011, Playfish drew approximately 55 million users a month, with over 37 million of those users coming from Facebook.¹⁰ Users can purchase "Playfish Cards" at Walmart, Walgreens, and Toys 'R' Us stores, at which point they can register on the Playfish website to begin earning "Playfish Cash" to use to purchase virtual goods within the games. On April 19, 2011, Playfish announced the change from Playfish Cash to individual cash for all games (except *Crazy Planets* at that time) and allowed users to trade for the new cash.¹¹

CrowdStar, based in Burlingame, California, is another developer of social games. Founded by Suren Markosian and Jeff Tseng, it has the fourth most monthly active users for Facebook applications.¹² Its most popular titles are *Happy Aquarium* and *Happy Pets*. CrowdStar turned down an offer by Microsoft to acquire the company for more than \$200 million.¹³ In May 2011 the company raised an additional \$23 million and plans on using the money to double their workforce and increase expansion on a global scale. CrowdStar plans to add about a hundred employees, including game developers, server developers, artists, producers, business analysts, and content managers. Peter Relan, CrowdStar's CEO, said the company needed to raise money to exploit opportunities for global expansion in places such as Japan, China, Eastern Europe, and Brazil.¹⁴

Background of the CEO

Mark Jonathan Pincus is the entrepreneur behind Zynga. He is also the founder of Freeloder, Inc., Tribe Networks, and Support.com.¹⁵ In 2009 Mark was named "CEO of the Year" in The Crunchies awards,¹⁶ and in 2011 was named Founder of the Year for 2010.¹⁷ Prior to his entrepreneurial endeavors, Pincus worked in venture capital and financial services for several years. After graduating from Wharton, he went on to obtain his Master's degree from Harvard Business School in 1993. In 1995 Pincus launched his first start-up, Freeloder, Inc., a Web-based push technology service. Individual, Inc. acquired the company only seven months later for \$38 million.¹⁸ In 2003 he founded his third start-up, Tribe.net, one of the first social networks. Tribe.net focused on partnerships with major yet local newspapers and was supported by *The Washington Post*, Knight Ridder Digital, and Mayfield Fund.¹⁹ Unfortunately for him, Mark's impressive background holds no merit with his irritated competitors, who have made their feelings widely known through a laundry list of threats and lawsuits.

Intellectual Property and Ethical Issues

In September 2009 Zynga was threatened with a lawsuit. Nissan claimed that their trademarks were used without consent in Zynga's game *Street Racing*. Zynga consequently changed the thumbnail images and renamed all cars that were branded Nissan and Infiniti to "Sindats" and "Fujis."²⁰ In October 2010 Zynga was criticized on *Hacker News* as well as other social media sites for filing a patent application involving the ability to obtain virtual currency for cash on gambling and other gaming websites. Many said that the concept was not new and that in fact significant prior art for the concept already existed.²¹ The unveiling of *Mafia Wars* generated a lawsuit from the creators of *Mob Wars*. An attorney of the parent company of *Mob Wars* said that by making *Mafia Wars*, Zynga "copied virtually every important aspect of the game."²² The lawsuit was later settled out of court for somewhere between \$7 and \$9 million.²³

California-based web developer SocialApps also brought Zynga to court, seeking damages for alleged "copyright infringement, violation of trade secrets, breach of written contract, breach of implied-in-fact contract, and breach of confidence." SocialApps claimed to have entered into an agreement with Zynga, allowing Zynga access to the source code for SocialApps' Facebook game *MyFarm* in exchange for an undisclosed form of compensation. According to the suit, Zynga was given the code, at which point Zynga failed to pay SocialApps. SocialApps claimed that *MyFarm*'s source code was the foundation of *Farmville*, as well as many of Zynga's similar games.²⁴ Following Zynga's January 2012 release of the game *Hidden Chronicles*, Forbes's Paul Tassi wrote that Zynga "refuses to innovate in any way, and is merely a follower when it comes to ideas and game design."²⁵

Ethical issues, although less tangible and therefore less definable than intellectual property, are equally as troubling when assessing Zynga's operations. A former employee of the company revealed quotes that he heard firsthand from CEO Mark Pincus, such as: "You're not smarter than your competitor. Just copy what they do and do it until you get their numbers." One contractor said he was presented freelance work from Zynga related to imitating a competitor's application and was given precise instructions to "copy that game."²⁶ Furthermore, other past employees have spoken out, even those at the senior level, to give insight into the corrupt ways that Pincus decided to operate the business. One of these past employees revealed a saying, "Do Evil," that was commonly used by employees in the office as a playful twist on the Google motto, "Don't Be Evil."²⁷

Unfortunately, Zynga's problems go beyond their lack of respect for other companies. The wrath of Zynga's business decisions has even been harshly felt internally. A former high-level Zynga employee came forth to tell about a situation he encountered when a group of designers brought a new and innovative idea to the table, only to

have it turned down by Pincus because of his wariness to attempt a new idea that didn't fit the "tried-and-true" mold of other successes.²⁸

Zynga has also been accused of taking advantage of their end consumers, particularly pertaining to a lack of security and safekeeping of consumer information. In May 2010 the Norwegian Consumer Council filed a complaint against Zynga to the Data Inspectorate concerning breaches of the Data Protection Act. According to the Consumer Council of Norway, Zynga's terms of use "do not offer a clear description of what is being collected in terms of information or what this information is being used for. Nor do they state how long the information is stored for or how it is protected against unauthorized access." They went even further with their forewarning, saying, "Many of the gravest examples of unreasonable and one-sided terms of use can be found in games providers such as Zynga."²⁹

Zynga Going Forward

Despite all the back-end controversy, Zynga's main concern had always been the end consumer and their satisfaction with the games that Zynga put forward. Although Zynga game users tended to be pleased with Zynga's games, many users also noted that there seemed to be recurring obstacles that limited that pleasure. For instance, a vast population of Zynga users complained of lag time while playing the games. Even more people complained that when problems arose, Zynga support staff was nowhere to be found. They had no customer service initiative and forced users to resort to sending their claim through email—which many people believe was ignored or never read. Furthermore, many believed that the company had made it too difficult to make real strides in the games without spending ridiculous sums of money. Based on their experiences, many users had come to believe the claim that Zynga was all about revenue generation and that everything else came second.

As Zynga looks to the future, where will their next big hit come from? With all of the acquisitions surrounding Zynga's past games, will they continue on the same path they have become so notoriously known for today and reap further accusations of imitating their competitors' existing games? Or will Zynga change their approach, gain a reputation for intellectual integrity, and begin creating true one-of-a-kind games—showing their capabilities as a leader in the industry rather than a follower? With all eyes on them as the market leader, it is certain that it will not be easy for Zynga to get away with some of their earlier stunts, especially now as a public company. The newly implemented board of directors has already announced their intention to assure proper decision making going forward, particularly

regarding corporate governance.³⁰ With all of the changes and concerns that must be accounted for as a public company, Zynga must watch its step or prepare to feel the wrath of its shareholders.

ENDNOTES

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