

Zynga: Margins On The Right Track, Users And Bookings Coming Next

While the market was again disappointed by Zynga's declining user numbers, we believe that this issue could be fixed soon as Zynga released in early Q3 "CSR2, a racing game which ranks among the top grossing apps on iOS and Google Play in the U.S., and will launch "Farmville: Tropic Escape" in late Q3 and "Dawn of Titans" in Q4. With profitability on the right track, we stick to our view that the company's earnings are at an inflection point.

For the second quarter in a row, mobile video game developer Zynga delivered a solid set of results with both Q2 bookings and EBITDA exceeding guidance and consensus expectations (\$175m and \$12m, respectively vs. a guide of \$160-\$170m and \$0-\$5m).

As the EBITDA margin is now firmly in the black (650bps margin gain year-on-year to 7% despite flattish bookings, after a 480bps expansion to 6% in the previous quarter), we believe the company's turnaround is well on track.

That said, Zynga's declining audience remains a source of concern (average daily active users fell 8% sequentially to 18m and average monthly active users dropped 11% to 61m) and probably explains the conservative Q3 guidance (bookings in a \$180-\$190m range and EBITDA between \$12m and \$16m).

While the market seems disappointed by these DAU and MAU numbers, we believe that this issue could be fixed soon. As Zynga released in early Q3 "CSR2, a racing game which ranks among the [top grossing apps](#) on iOS and Google Play in the U.S., and will launch "Farmville: Tropic Escape" in late Q3 and "Dawn of Titans" in Q4, the user base is likely to stabilize in coming quarters and to increase in FY17.

Hence, we stick to our view that the company's earnings are at an inflection point. Any uptick in bookings could give a major boost to EBITDA margins in light of recent restructuring efforts and we estimate that any 10% top line upside would translate into at least 50% EBITDA growth or 500-600bps margin expansion. Assuming new titles gain traction as we expect, Zynga could be a \$1bn revenue business with 20-25% EBITDA margins by FY18 (vs. \$700m bookings and 2% margin last year).

While the company's earnings recovery potential is a major catalyst, the stock's valuation is another major reason to own Zynga. Considering that the cash and real estate are worth \$1.4bn (or \$1.8 per share), Zynga's gaming assets are valued at only \$1.1bn.

First, this suggests that the company would be an easy target to swallow for most predators out there. We believe that Zynga could attract the attention from players seeking to give fresh impetus to their mobile gaming ambitions (Electronic Arts, Japanese publishers?) at a time when the strategic value of mobile gaming assets is rising, as illustrated by the M&A frenzy in the industry (see the recent acquisition of Finnish developer Supercell by Chinese Internet giant Tencent).

Second, Zynga's gaming assets multiples (EV/Sales of 1.1x for both 2015 and 2016) appear compelling when compared to those of French rival Gameloft (acquired by media conglomerate Vivendi for 2.3x 2015 sales), not to mention Supercell (4.4x).