

Inside Social Apps 2010: Investors Talk Big Acquisitions and Mixed Opportunities

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Inside Social Apps 2010 ended today with a panel on investing opportunities in social applications and games. While most of the investors weren't too bullish on the short-term opportunities for small developers, they do believe there are all sorts of short and long term opportunities.

The panelists:

Maha Ibrahim, General Partner, Canaan Partners

Nick Lawler, Managing Director, Maverick Capital

Rick Thompson, Co-founder, Playdom, and Investor

Tim Chang, Principal, Norwest Venture Partners

Atul Bagga, VP Equity Research, ThinkEquity (Moderator)

Bagga: Rick, you've been working in this space for years, can you share any more about your perspective today?

Thompson: Two years ago if we were here talking about 40% penetration rates, I would have been forced to sober up. Today, it's also remarkable that DAU traffic has been flat for the last 6 months. The basic reason is that Facebook has severely dialed back its virals. I'm impressed that we've been able to hold our own.

Viral has taken a back seat. People are taking more time to develop game mechanics, and building original games. This paradigm shift takes time for us to get our heads around, and to adapt to. I think this will take several months and we'll be back to growth.

Long-term, my guess is that 90% of users will be in social gaming.

Bagga: Where will the growth come from?

Thompson: Facebook will double. ARPU will double. The focus will be on compelling, engaging user experience.

Bagga: Virality is going down. How do new companies compete?

Ibrahim: This is a really big challenge. It will be a lot harder for new entrants. Even with non-gaming developers with big audiences, there's an almost inevitable shift to social gaming. Having users is a huge barrier to entry. But I also think it's inevitable that Facebook will return to a more viral state; they'll eventually realize that they need to expand.

Chang: Everybody's for sale right now. Do you raise money or flip to Zynga? There are a lot of merits to getting acquired now. The three legs of the stool have been virality, cross-promotion and advertising. The virality leg has been cut out.

Thompson: I agree with tim that the stool has been unbalanced. But I think strictly looking at the Facebook platform, they have other levers. This ties into my investment thesis for creatives launching new studios. I think it will be made more friendly. Making the platform less transparent would help, because otherwise you're a target as soon as you start growing. I could see Facebook coming up with custom ad programs for innovative new apps — a little runway, that would also put money in Facebook's pockets. I think there's a host of things that Facebook could do, just as virality has changed the game.

The game is not over for the indies, because they're fundamentally also in fb's best interests.

Ibrahim: I agree about Facebook, but not about independent developers. Right now, it's not a great environment to be an independent developer growing apps. But there are also some opportunities for a large audience, like internationalization, that are untapped by even the big guys. If you're in Turkey or Korea or other large social markets or gaming markets, the opportunities are still good for small developers. Others are developing social apps in context of mobile or console — inevitably consoles are going away, but they have huge market share. If you could make a console game more social, maybe dumb down, there'd be a big licensing cost but still an opportunity.

Bagga: We're seeing developers who are big off of Facebook getting more serious about Facebook. In this environment, how do you evaluate a new business and company?

Ibrahim: So much of other games — like most casual games — is about the title franchise. Those gamers don't associate the title with those companies. They think about it being unique and intriguing. As those companies move to social, hopefully they'll be able to attract that audience to Facebook, from converting users from sometimes non-paying to paying, some model like that. But fact that it's a popcap game won't hold a lot of weight.

Lawler: Tencent's investment in DST was big news. Expect Chinese and Korean developers to have a much bigger influence in the US. In a lot of ways, they invented the virtual goods model. The business is big in china and grew 40%. They have large scale gaming operations, money, and they have big markets. They look at the situation and they think they still have competitive advantages. They all have large cash balances, and very high growth expectations, especially the public companies. Investors expect some of them to grow 50% every year. Eventually they'll start looking at markets like the US for this future growth. I think they have lots of expertise and I would be surprised if they didn't take a more active role over the next eyar or two.

Bagga: On the one end you have games like World of Warcraft that have relatively few users but monetize each user well, and on the other end you have social games that have lots of users but monetize relatively few of them. Is there somewhere in the middle?

Lawler: I think they'll probably do both. Leading japan company DeNA has opened up its mobile platform to third parties, they also have their own games, and they've taken their own games to Mixi and elsewhere, where they're now monetizing at very high levels, doing \$30 million in revenue a month. That's both on their own network and on third party networks, with ARPUs that would rival any US game company. Then you have some chinese companies doing interesting things with the business model. They started with subscriptions but they've moved to primarily item-based VG — and now they have hybrid models. A company like Tencent has a virtual item model but it's selling subscriptions where you get some set usage for particular items. You're creating a hybrid which presumably has lower churn than strict item based models.

Chang: Asian games have been based on downloads. The US has pioneered Flash and browser-based play. Now when Asian game companies realize the power of social, you'll see them take off with browser games — games with high production value, that are free.

Ibrahim: Many companies have strategies to move off Facebook. They don't want to be beholden to whatever tariff is coming down road, benefits of the tariff aside. You also have the asian companies looking at getting in, even as social gaming companies are looking at moving off. It's a delicate dance that all of these companies are going to need to do when they converse with many of the Asian acquirers that are coming.

Lawler: Is there room for independents? Until churn rates come down, there's still room for indies. Any time you ahhaveve a substantial change to platform, there will be disruptive opportunities. You can look to video gaming for examples of that. Any time a new console has launched you had large new franchises getting created built on original game play.

Bagga: Who will look at acquisitions?

Chang: The publishers are companies like Zynga, Playdom, CrowdStar, and Ngmoco on the mobile side. EA has already bought Playfish.

There's Ubisoft, THQ and other traditional game companies looking. All the media companies have mandates out to their bankers — CBS, Disney, Viacom [He goes on to list basically all big US media companies].

On the Asian side, they're all aggressive. In china there's Perfect World, Giant, Tencent, and others. Japan has companies like DeNA and Softbank. And there's the big Korean game companies.

There's also the new war between Apple, Google and Facebook, and maybe Yahoo if they get their act together.

Bagga: How do you value these companies?

Ibrahim: Chinese companies have money and they're doing the valuing. There are few comparables — so high. Venture investors always care about top line revenue growth. If it's showing a nice ramp, especially with social network, that helps — there's also the hype cycle. We're at the top of it. We'll see very, very attractive valuations for companies.

Chang: Investors have normally looked at DAU base, revenue and earnings. It's nice to do P/E. But not all DAU are created equal. Some monetize much better. China games have massive player bases but the ARPUs are infinitesimally small. Japan has a small market and very high ARPUs. So Chinese developers having been going to Japan, localizing flash games at much higher ARPU rates.

Bagga: What sort of room is there for social gaming monetization growth?

Ibrahim: When you look at the Chinese and Korean models, games are much more engaging. The k-factor might be lower, but engagement will be higher. Naturally in more affluent countries, this will lead to higher ARPUs at the end of the day. The trend is away from highly viral high-churn games.

Chang: Some of these games in Asia can monetize up to 10% of users, which is especially strong if you can get some part of that as a subscription. If Facebook is 1% to 3% of the total, it's possible you can still get up to 10%. If Facebook has half the world's internet population on it and half are in games, that could mean up to 3 to 4 times revenue growth.

Bagga: What about other platforms, like the iPhone OS 4?

Thompson: For the last few years I've viewed mobile as a secondary opportunity, as a way to reengage social gamers. With OS 4, I'm totally coming around and joining mobile camp. Apple has shown they really get it and want to play in social gaming with the new Game Center, invites and notifications. Put that on top of a healthy social graph — phone contacts. And if Apple does, then Android will. I had my iPad, I love it, I have games I can play on the road, and in a way I can't play on Facebook. I'm being won over. I appreciate they have another platform working to earn our business. I'm thinking if not next year then the year following, mobile will be like what web-based social games are now.

Chang: The iPhone app started off with no virality. So developers came up with their own ways of cross promotion and incentivized game play. Now, Apple is adding in virality while Facebook is taking it away. I wonder if we'll developer-driven social platforms come back on Facebook?

Ibrahim: Mobile has been bad because of the carriers. As carriers invest heavily in their networks, there will be huge advancements on infrastructure. Also in smartphones and battery life. This will enable very usable mobile games.

Bagga: Is this good for social gaming?

Chang: I think it will be seamless. Mobile and social have converged in Japan. HTML5 should run native mobile and online social games.

Audience question: What are the requirements for independent developers who can make it? Lots of DAU, a capital reservoir?

Ibrahim: I think the window will open again, Facebook has every reason to. But for the time it's been closing, and Facebook has had many reasons for that. One of my portfolio companies amassed 30 million users through other apps and now it's doing social games. They can pump these social games into that installed fan base. It's hard to start from scratch. It feels like starting a destination site. Once you get to some level of scale and originality, then a company like Zynga will give you an offer, etc.

Farmville requires much more DAU to monetize than others. But it's about a lot more than DAUs — that class will change over time.

Chang: Many of us are talking about the gamification of life, of viral mechanics, things like that. Areas like health and wellness... lumos labs... Enterprise is ripe for game. You can imagine a customer service center, using a FarmVille-style system to have employees "harvesting" calls, like FarmVille. That could make the job 20% more enjoyable and reduce employee churn.

Audience question: What do developers need? Where are there still opportunities?



Thompson: Everyone stumbles on scaling software and apps. I'm sure there's a fit there.

Ibrahim: My cause celebre is payments. People who want to pay but can't, who don't have a credit card or whatever. That's a huge area of focus for larger game companies. Most take it in house. They realize that's an area they can innovate on. It's not that hard. A lot of offer companies will get commoditized. But when you think about opening new markets, that payment thing sticks out like a sore thumb.