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Industry Report

Think Entertainment: Gaming

Virtual Goods: An Interview With The Founder And CEO Of Live Gamer

Reason for Report:
Industry Update

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THINK SUMMARY:
We had a chance to speak with Mitch Davis, the founder and CEO of Live Gamer, one of the leading payment and ecommerce solution companies for virtual economies serving more than 85 million users. The company sees payment solutions as a commodity business and ecommerce suite (analytics, merchandising, item management, and marketing) as much more valuable, given its ability to drive up conversion rates and ARPPU for publishers. The company is seeing a strong interest in the micro-transaction model from traditional media companies (newspaper, TV, and films) to monetize their content, which could significantly expand the market opportunity, which at present seems to be largely focused on online gaming.

KEY POINTS:

- Live Gamer is one of the leading payment and ecommerce solution companies for the virtual economies, akin to an SAP for real goods business, according to Davis, powering 85 virtual economies and serving over 85 million users.
- The company is focused on online gaming but is seeing strong interest from traditional media companies like newspaper, magazine, television, and film studios in adopting a micro-transaction model to monetize their existing content.
- According to Davis, the size of the online gaming market could be about $15 billion, and assuming a 7% take-rate, the market for ecommerce and payment solutions could be about $1 billion currently and could grow to about $2 billion in the next three to five years. Including the emerging opportunity from the traditional media space, the addressable opportunity could grow to about $3 billion over the next three to five years, according to the company.
- While payment gateway is an essential part of publishers, the company views the ecommerce solutions as much more value added (as compared to the payment solution that generates about 2% revenue share for Live Gamer) given its ability to help customers increase usage, enhance retention, and drive up the conversion rates and ARPPU (Average Revenue Per Paying User).
- The company sees the publishers' in-house IT departments as the biggest competitor. Outside of that, competition seems to be largely limited in payment solutions, according to Davis, and the market could be big enough to accommodate four to five vendors.
- The company sees micro-transaction on a mobile platform as a burgeoning opportunity and is working to launch its solutions for mobile platform.

Please see analyst certification (Reg. AC) and other important disclosures on pages 6-8 of this report.

Atul Bagga, ThinkEquity (AB): Can you explain your business and why should investors care about Live Gamer?
Mitch Davis, Co-Founder and CEO Live Gamer (MD): Live Gamer powers digital economies and digital commerce for the publishers of digital entertainment and content. The best way to think about it is that we're like the SAP of digital economies. We provide a full technology and services solution to manage ecommerce around virtual goods and content. Our solutions can make a meaningful difference to the user experience and to the publishers' financial performance. For investors, this business has merits since it is a high-growth infrastructure play because we power hundreds of games, social networks, and entertainment properties and so are not susceptible to the hit-driven nature of individual entertainment properties. We benefit from the rising tide of the virtual goods economy—a very successful business model for game companies that is now expanding to other types of interactive entertainment.

AB: Who are your target customers and can you highlight a few of your marquee customers?
MD: We operate in 23 different countries currently powering micro-transactions and virtual economies with our Total Commerce Solution for over 85 interactive entertainment clients for more than 85 million users. By 4Q10, the Live Gamer network will exceed 250 million users. Our customers fall into three categories: (a) core gaming companies; (b) casual/social gaming and social networks; and (c) digital entertainment companies. We work with companies ranging from worldwide game publishers such as Sony Online Entertainment NHN USA, Funcom, and Gravity to social game companies and networks such as Quepasa.com and Ohai.

AB: Can you talk about the applicability of this model for the traditional media?
MD: Over the last eight years, Live Gamer has seen ARPPU's in our network grow to a global average of $28 per month. In the U.S., it is slightly over $24 and growing at 20% CAGR. Even a mature market like Korea is showing growth over the last three years as a result of more sophisticated offerings and technology. Our Korean ARPPU is $15 and Japan runs at over an impressive $60. This is a high-margin business because the cost of a Virtual Good is close to zero, so Publishers with a micro-transaction-driven model are showing 40-60% EBITDA. Those economics are very attractive to traditional media and entertainment companies.

We're seeing strong interest from traditional publishers, newspapers, magazines, television networks—both broadcast and cable, as well as film studios and other types of entertainment properties who see the success of paid content in the game and social sectors and are beginning to explore how to leverage for more traditional linear content and franchises.

Traditional media has historically had one or two revenue models. TV for instance is largely a one revenue business model—a model that is threatened by media fragmentation and changing consumption habits of the core audience base, namely toward online. This shift necessitates that content owners and distributors expand their revenue base and provide experiences that map to the new demands of viewers. Those same viewers are often video game players and heavy users of social networks and so have are accustomed to virtual goods, virtual items, and micro-transaction-driven models.

With this micro-transaction model, IP owners can offer a segment of content freely available to a wide audience and look to monetize all the way through but with a focus on the top 5-10 percent of users. As we see in successful micro-transaction "free-to-play"-based online games, the audience can then self-select into the price point and consumption habits best for them, creating the most-optimized scenario for price discrimination and, thus, revenue. Going one step further, adding social elements around otherwise linear content can lead to a user experience that is highly engaging, viral and social, resulting in deeper engagement and average revenue per paying user that can equal tradition cost per thousand metrics.

AB: Can you explain your business model?
MD: Our business model is very similar to other software and services companies. We derive revenue from services fees, integration, and occasionally custom work or consulting. We align our interests with our publishing partners in that we share a percentage of the transaction revenue. In some cases there's a straight licensing fee.

AB: What is the typical break up of revenue between these three revenue streams?
MD: We derive over 70% of revenue from transaction/service fees.

AB: Payments versus the ecommerce solution—what is the bigger part of your business?
MD: The ecommerce solution certainly drives the primary value for our publishers and majority of our revenue. Payment gateways are an essential part of the business, but of limited value to publishers. It is kind of a 2% business. But providing the total commerce solution that enables a digital economy is a significantly larger set of services and solutions and clearly more valuable.

Our clients are generally focused on three goals: increasing users, usage, and ARPPU. Our technology helps drive all three, with an emphasis on increasing ARPPU. Live Gamer's tech stack and services focus on features that deliver the highest free-to-paying conversion rates, highest revenue per user and those that help to boost user retention. Those features are typically centered on effective item management, sophisticated analytics, marketing, and merchandising of virtual content to end-users.

AB: Can you give us some sense what is a size of addressable market?
MD: The addressable online gaming market is in the order of $15 billion today—hardcore games at about $4 billion, casual and social at about $7 billion, and secondary market of virtual goods at about $3-4 billion. The derivative market for our transaction solution business, assuming a 7% take-rate, is over a billion dollars. Our addressable market is benefiting from two growth factors—one is at 40% CAGR in the micro-transaction-based gaming market, which itself can expand Live Gamer's addressable market to greater than $2 billion in three to five years; and then the opportunity in the related categories of digital entertainment could be at least 50% of Game market or $7.5B over the next three to five years.

AB: Can you talk about a few secular drivers that are driving growth in this market?
MD: There four major drivers. Firstly, increased broadband penetration and social activity on the Web are very significant drivers. When you've got 390 million users on Facebook and 350,000 apps, it drives a lot of transactions. My sense is that the micro-transaction value of social networks is probably worth north of a billion dollars today and heading to five-plus billion dollars by 2012.

Secondly, advances in game development technology have lowered the cost and increased the speed of development. Publishers are delivering a portfolio of quality entertainment experiences on the Web. The current-generation MMOs are great games; they're fun to play, there's a ton of social interactivity in there, and it's a rewarding entertainment experience. Similarly, innovations in social gaming have created compelling game experiences with low budgets and short development cycles. Both game forms are structured around item-based game leveling—a significant driver for micro-transactions.

The third driver is the global recession. Since the disposable income available for entertainment has reduced over the last two years, it has brought a lot of people into free to play games from expensive box games and subscriptions and accelerated the sector's growth.

Finally, mass distribution of free-to-play games has changed the demography of gaming. That has bought a mass market to micro-transaction driven entertainment.

AB: How easy or difficult it is to sell your solutions now versus it was about a year ago?
MD: A year ago, the market was growing so fast and consumer demand was so strong that publishers were just focused on creating virtual goods for distribution inside the games. Now they've moved to another level of sophistication and they need to analyze their demographics, their ARPUs (Average Revenue Per User), their SKUs performance, payment method effectiveness, and so on. In many respects, it resembles the kind of sophistication that Amazon or Wal-Mart have around managing their businesses. Yes you're running a game-as-a-service, but you have to be able to merchandise virtual goods and manage your digital economy at optimal levels. We see a lot of publishers that are exceptionally good at that. They're very data hungry; they want high-powered analytics and multivariate simulations.

AB: What is your growth strategy? Where do you see your growth coming from—is it more about increasing your take rate or adding more verticals or adding more gaming publishers?
MD: A number of publishers that have been in the space for a while are still using home-grown solutions and a significant number of those publishers are moving to third-party software like ours because our R&D efforts have developed a more-mature, more fully-featured, and more-robust solution that offers significant advantages. The second category is the new players that are entering the space need quick and easy solutions. Then there is geographic growth as we move into different markets. For example, South America has become a real focus for a lot of publishers. Then there is transaction growth, just natively and organically. And the last category for Live Gamer is opening up of new verticals in digital entertainment and online content where those publishers are looking for an additional revenue stream.

AB: Can you highlight any data around penetration of third-party solution versus home0grown solutions?
MD: If you look at Korea, which is a very mature market, there are four or five publishers that have home-grown solutions and the most other publishers use third-party solutions. The reason being that the R&D investment required to build a highly scalable, feature-rich industrial-strength solution is significant. So we think that the market will be all but the top few

publishers in each of the categories—and even among those, we're seeing exceptions.

AB: Who do you consider as your competitor currently, and looking ahead who could be your potential competitors?
MD: It depends on which sector of the market you're looking at. For example, there's a lot of competition in the payment gateway space. There are a number of traditional providers in payment gateways in e-commerce and a number of traditional physical goods commerce that are moving into this market. In our view, that is a more commoditized end of the market, and we see lot of price competition in that area.

When we think about the high-end technology, that makes a significant difference for our publishing partners and their ARPPU performance, we see much less competition, and we see even less competition outside of the gaming vertical. In the gaming vertical, our principal competition is probably in-house development right now but that's becoming less of a force because our technology makes a pretty compelling case for buy versus build. In the gaming vertical, we see people like FatFoogoo and PlaySpan.

AB: Do you think companies like Macrovision can be competitors potentially?
MD: Once the virtual goods market becomes a significant multibillion-dollar software and services market, it's going to attract a lot of interest from people that are in tangential markets. There's a lot of complexity in and around virtual goods and digital economies that are hard to solve. I think in two to three years time, it would be difficult from an R&D as well as market-knowledge standpoint to be able to compete against focused organizations that have a rich history and volumes of historical data and experience in building specific products for virtual economies.

AB: What is your secret sauce? What part of your business is difficult for someone else to replicate?
MD: We have a couple of things that we think are very helpful to our publishers. One is international experience and data. Second, we've been in the business since the beginning and our technology is mature and feature rich. It is also significantly scalable and can handle high-level concurrent usage. Ultimately, Live Gamer has an exceptional team that continues to innovate on a very strong business enabling technology.

AB: Are there any compelling new offerings that you might be working on we should be paying attention to?
MD: Live Gamer has a number of innovations being released in 2010. We can't mention all of them here. Three we can discuss include firstly enhancements to our core platform that improve marketing and merchandising, storefront capabilities, parental controls, and fraud controls for our Publishers. All of which is designed to increase ARPPU and improve margins for Publishers. Secondly, we will release the next generation of our Social Networks solution. Thirdly, mobile is mission-critical to our customers and you can expect to see an exciting announcement around the burgeoning mobile market micro-transaction opportunity.

AB: When you look out over the next few years, what do you see as the big challenges for Live Gamer?
MD: I think there's going to be a lot of focus from publishers on integrated approach to revenue optimization. We hear from our partners that they are looking beyond the notion of the super-user to how can they monetize yield under the entire curve of users. I think there's innovation required in and around combinations of virtual goods, virtual currency, and advertising. Secondly, for the publishers that we're working with and talking to today, those incremental geographical markets become very important over the next three to five years. I think mobile micro-transactions are going to be very significant over the next few years. And again, continuing to innovate around the business model for the end-user is going to be important as well.

AB: Can you give us some sense how big Live Gamer is and how fast you might be growing?
MD: We have about 85 million+ users on our network today and that will quadruple in 2010 based on the current software integration schedule. That equates to around 12m monthly transactions by 4th Quarter. Live Gamer has 60 people, spread across four offices – New York, L.A., San Francisco and Seoul Korea. We're adding staff now and our revenue is growing at about 30 percent month over month.

AB: Over the next three years, where do you see Live Gamer—do you see yourself as a stand-alone private company, as a part of a bigger platform, or as a public company?
MD: There is a multibillion dollar addressable market here, so Live Gamer is focused on continuing to enhance our high-quality technology offering so that it solves the needs of our publishers today and for the foreseeable future. Today, we have over 80 full scale clients, and we expect revenue to double every quarter through 2010. We're going to expand across verticals, and we're going to grow internationally. Live Gamer will also continue to add value to the top of our technology

stack. And if we continue to execute at a high level, then opportunities will emerge.

AB: Thank you for speaking with us today.

INVESTMENT RISKS:
Gaming continues to be a hit-or-miss-driven business, and predicting successful titles from unsuccessful titles is extremely difficult. The risk is especially high for the new and unproven IPs, and a company's reliance on the new IPs and the titles in the established franchises to reach the revenue target opens it to risk of a revenue miss.

Macro headwinds and popularity of the used games and free-to-play online games. Given the current macro headwinds, used games and free-to-play online games create higher substitute competition for video games.

The Industry is dependent on console cycle; unexpected start of the new console cycle will likely constrain the revenue growth and affect profitability of gaming vendors.

COMPANIES MENTIONED IN THIS REPORT:

Company	Exchange	Symbol	Price	Rating
Amazon.com, Inc.	NASDAQ	AMZN	$127.14	Buy
Wal-Mart Stores, Inc.	NYSE	WMT	$53.68	Buy

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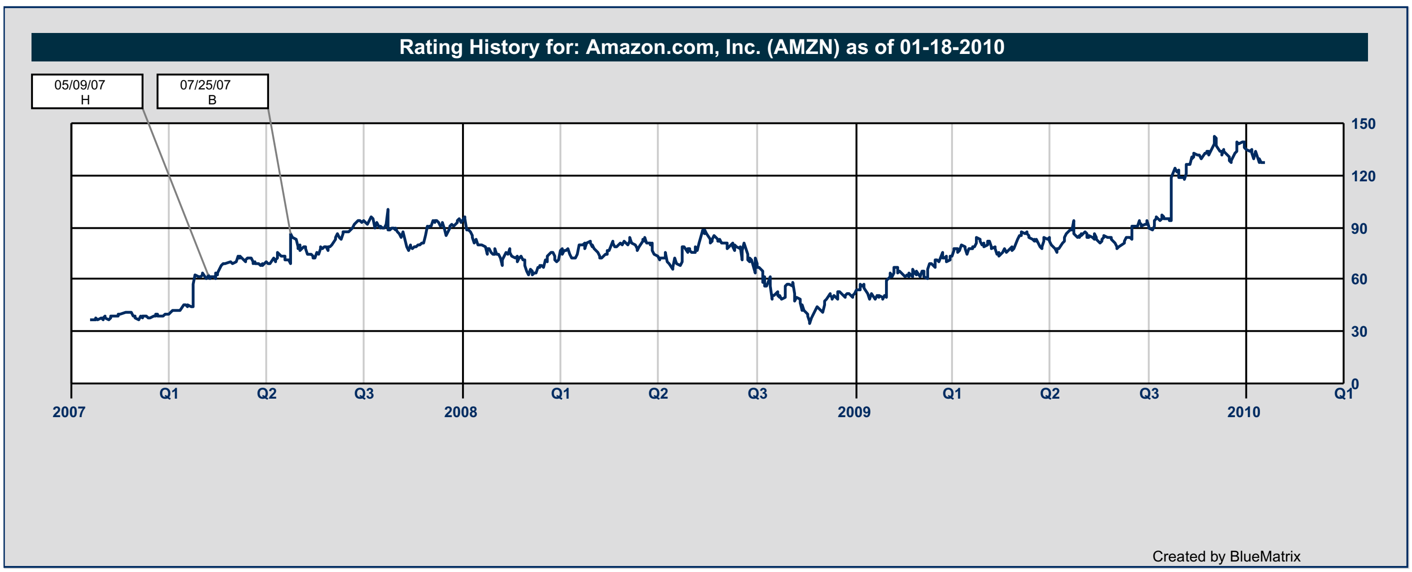

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ThinkEquity LLC

			IB Serv./Past 12 Mos.	
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BUY [B]	**121**	**65.80**	**12**	**9.92**
HOLD [H]	**60**	**32.60**	**1**	**1.67**
SELL [S]	**3**	**1.60**	**0**	**0.00**

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