

# Inside the App Economy

## Beyond the goofy games is a world of useful programs that's making fortunes and changing the rules of business

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It's easy to shrug off the kooky world of apps. The bite-size software programs people load onto their mobile phones or tap into on the Web seem mostly to be silly games and pointless novelties. But look past the beer-drinking apps and flatulence programs and you'll see something significant taking shape: a bustling app economy that's creating new fortunes for entrepreneurs and changing the way business gets done.

It's happening with dizzying speed. Just two years ago, almost none of this existed. Apple's ([AAPL](#)) App Store, the most popular destination for mobile-phone programs, was launched last summer. Now there are more than a dozen rival stores, and at least 100,000 apps have been created. Some startups that staked their claim in the app economy have become large, lucrative businesses in just a few months. Two-year-old Zynga, which makes popular game apps, is already profitable, with more than \$100 million in revenues. By comparison, Google ([GOOG](#)) didn't start making money until its third year—and still had less revenue.

There are serious business tools among the thousands of new apps. Salesforce.com's ([CRM](#)) programs let executives manage customer relationships from an iPhone or BlackBerry. Oracle ([ORCL](#)) apps let managers check inventory or get a snapshot of a business unit's performance. The computing that people used to do at their desks increasingly can be done on devices they can carry anywhere.

### Early Days

Apps will help determine technology's next big winners. The success of Apple's iPhone is due in large part to the fact that the company can offer customers more software choices than any rival. Research In Motion ([RIMM](#)), maker of the business-oriented BlackBerry, has scrambled to catch up and has made progress. But established giants such as Nokia ([NOK](#)) and Microsoft ([MSFT](#)) are struggling to get traction, raising questions about their prospects.

These are such early days, no one knows exactly how big the app economy is. Companies make money from selling apps, from ads within apps, and from selling digital goods used in apps. Add it up and analysts figure it's at least a \$1 billion market today, headed for \$4 billion by 2012. Not bad for a brand-new business.

True, much of the money these days comes from goofy games. One popular app is I Am T-Pain, named after the performer, born Faheem Najm. Fans can download software to their iPhone and mimic his robot-like voice. But it's time to heed the opportunities in this fast-evolving world. The \$2.99 T-Pain app has put its creator, a year-old startup called Smule, on track to pull in \$3 million this year. "Apps have moved into the mainstream. The world's changed," says Jeff Smith, Smule's chief executive.

### Zynga's Zing

**Revenues are soaring on the success of 'Social Game' Apps like FarmVille**

Early this year, Mark Pincus, founder of the tech startup Zynga, huddled with staffers in his company's San Francisco offices to brainstorm new product ideas. Zynga develops game apps that can be played on social networks such as Facebook or mobile phones like the iPhone, and Pincus needed a follow-up to a popular poker app. One employee suggested a farming game, where players could grow digital crops and sell them to make virtual money. Pincus liked the idea and gave it the green light. Four months after its launch, FarmVille is one of the most popular apps in the world, with 60 million people playing it in the last month. "It just exploded," says Pincus.

Such is the nature of business in the burgeoning app economy. Success—and a flood of money—can arrive practically overnight. Zynga doesn't charge users to play FarmVille, but it does sell digital crops, cattle, and farmland. Corn seed, for instance, goes for the equivalent of 10 cents; cows run 20 cents each. All those digital goods add up. Zynga pulls in its nine-figure annual revenues from FarmVille and 20 other games.

The company may be just getting started. U.S. revenues from so-called social games have surged over the past two years to \$720 million, and analysts project they will grow to \$2 billion by 2012. "We are seeing very strong success with these companies," says Atul Bagga, an analyst with investment bank ThinkEquity. "They are basically letting customers choose [how much money] they want to [spend] in a particular game or application."

Zynga has the vibe of a young Google ([GOOG](#)). Just like the search giant in its early days, the company has a masseuse on staff and chefs who serve up two meals a day to keep employees from wasting time going out for food. It has weekly keg parties, like the ones Google's founders once hosted. And Pincus has tried to maintain a light atmosphere, even as the company has grown to 468 employees. The winner of a monthly poker tournament gets treated to a one-day Lamborghini rental. Pincus calls the atmosphere "ghetto Google."

### **Seeds of Success**

The company's offices are in the industrial Potrero Hill neighborhood of San Francisco. On a recent October day the 43-year-old Pincus, clad in jeans and an untucked oxford shirt, drew three intersecting circles on a whiteboard. He says the next great opportunity on the Web lies at the intersection of three trends—apps, Web services, and small online payments from consumers. Pincus sees apps not as products but as ongoing services that users tap into from Facebook or the iPhone and pay for in small increments. "Our story has been about finding games people could play forever and giving them a reason to do it," he says.

The strategy is in full swing in the FarmVille studio at Zynga, where a 30-person crew manages the company's biggest hit to date. The game is an odd success for the digital world: Users get a virtual plot of land to farm as they see fit. As they grow crops and earn currency, they can use the money to buy more seeds, animals, and tools like tractors. Since all players are logged in to Facebook, they can work with friends or co-workers, or they can compete against them for farmer bragging rights. There are roughly 20 times more people playing FarmVille these days than there are actual farms in the U.S.

For a hit like FarmVille, the work is never done. A wall-size chart in the FarmVille studio lists the various virtual items up for consideration in the next round of improvements to the game, culled from staff ideas and requests from users. The ability to get feedback and act on it quickly is a break from past models, says Mark Skaggs, who runs the FarmVille group. At large companies such as Electronic Arts ([ERTS](#)), where Skaggs used to work, "You might design a feature and not know until two years later whether it was good or people liked it," he says. "Here, you can design a feature in a day and put it in the game the next day."

As Zynga's games have grown, they've become giant test labs for new ideas. "Every single click is being recorded," says Vish Makhijani, Zynga's chief operating officer. That means Zynga can quickly

find out the impact of small adjustments—such as changing the size of a cabbage patch in FarmVille or the cost of a new gun in the game Mafia Wars—on retaining users and increasing revenue. One recent success: digital sweet potato seeds that cost \$5 a packet. The seeds, which of course cost nothing to duplicate, pulled in more than \$400,000 in three days.

The rich opportunity has fueled aggressive competition. Zynga's primary rivals are London's Playfish and Mountain View (Calif.)-based Playdom. Playfish is known for a game called Pet Society, which lets people adopt online creatures and then dress them up in designer clothes, while Playdom's hit game is Mobsters, in which people try to gain skills, alliances, and wealth. All three companies are private and don't disclose financial information.

The game makers compete for users across all sorts of technology platforms. The big targets are Facebook, with more than 300 million members, and Apple's App Store, with more than 50 million iPhone and iPod touch users.

Lately, Playdom and Zynga have also been dueling in court. A lawsuit filed by Zynga in September alleges that several former employees recruited by Playdom supplied the competitor with the Zynga Playbook, a proprietary document the complaint describes as "the recipe book that contains Zynga's 'secret sauce,'" referring to its game-making techniques.

The rapid growth and sharp rivalries have drawn comparisons to the early days of Web pioneers such as Amazon.com ([AMZN](#)) and eBay ([EBAY](#)). One significant difference is that the apps business has virtually no barriers to entry, meaning it is hard for any company to maintain a lead. Today there are thousands of small developers who crank out apps that don't make a dime.

The perk-heavy culture at Zynga is certainly reminiscent of the dot-com days. Inside its office for human resources, 160 small paper bulldogs are tacked on the wall, one for every new hire in the past quarter. There's a cooking staff of 17, and most game studios have their own kitchen. Several rooms are equipped with Xboxes and board games, and are designated "meeting-free areas."

### **New Staffers and a Couch**

With employees grouped into a series of discrete loft offices, Zynga's operation looks more like 11 small startups glued together than one large one. It's a reflection of how the company is run: Studio heads set goals and are given freedom to achieve them any way they can. Those who succeed are rewarded with cash and stock bonuses and are granted extra resources such as new hires. When a new game called Café World recently set a company record for growth, signing up 16 million users in its first two weeks, its head, Roy Sehgal, was rewarded with a bevy of new employees and the leather couch he had been requesting for his office for weeks.

Pincus calls this style of management "true meritocracy" and says it's modeled partly after the approach at Amazon. It applies to regular staffers as much as managers. In his first three months in the poker group, Harsimran "Sim" Singh moved up the company ladder three times for helping to bring growth back into the company's longest-running game, Texas Hold'em. A year after landing at Zynga with no direct reports, the 25-year-old runs the entire poker unit, a team of 45.

The Amazon influence affects how Pincus conducts his board meetings. Each time he meets with his directors, he begins by recounting whatever issue kept him awake the night before. It's a tip he learned from Amazon CEO Jeff Bezos, an acquaintance and role model who shares a director with Zynga.

One matter getting airtime at board meetings of late: When should the company consider going public? Zynga doesn't need cash. It raised \$39 million in venture capital in 2008 and hasn't touched the money since. But a publicly traded stock would give Pincus the currency to make deals or dole out employee options. Still, Pincus wants to protect the culture he has created. "We all make so many compromises in order to build our businesses that we wake up one day and we've created a company that we don't want

to work at," he says. "I wanted to create a long-term home."

## **The Man Behind Apple's Apps**

### **How Eddy Cue and his team keep the App Store ahead of the competition**

If you had to choose one person who makes the world of apps go around, Eddy Cue might well be it. Apple ([AAPL](#))'s vice-president for Internet services is the architect and overseer of Apple's App Store. Millions of iPhone owners have downloaded the 85,000 apps available from the App Store. That's light years ahead of rival offerings from Google ([GOOG](#)), Microsoft ([MSFT](#)), or Research In Motion ([RIMM](#)).

Cue and his team seem on track to ensure that those mobile Internet wannabes don't close the gap anytime soon. While no rival has even 15,000 apps, his team keeps tweaking Apple's offerings to make them more attractive to consumers and useful to developers. On Oct. 14, for example, Apple told developers that for the first time they could give away apps on a trial basis and then ask consumers to pay later. "Apple has done a ridiculously good job, and now they're taking it to the next level," says Jeff Holden, chief executive of Pelago, which makes apps for the iPhone and other devices.

Cue, 45, joined Apple as a lowly staffer in the IT department in time to witness the company's darkest days during the mid-1990s. He not only survived a major housecleaning after Steve Jobs returned to the company as chief executive in 1997 but emerged as one of the CEO's most trusted lieutenants. When Apple found itself playing catch-up in digital music early this decade, Jobs put Cue in charge of creating the iTunes Music Store. While far less ambitious efforts floundered, Apple's site was doling out millions of songs within weeks, with nary a hitch.

### **Hollywood Connection**

Over time, Cue's role expanded from running the iTunes store to cutting deals to fill it. While Jobs often finalizes agreements, Cue does most of the heavy negotiations with record labels and Hollywood studios. "Eddy doesn't have attitude. That's part of his success," says one former Apple insider. "In an industry with lots of big egos, he can hold his own without saying, 'I'm the inventor of iTunes, bow before me.' One favorite approach is for Cue to "play good cop to Steve's bad cop," says the ex-employee. Apple declined to comment for this story.

Cue stands out within Apple's hard-core culture for his friendly, let's-get-a-beer manner. A rabid Duke University basketball fan, he's described by insiders as an "East Coast guy's guy." But he's one of a tight-knit group that makes sure that Apple devices, software, and services work smoothly together. Many app developers don't know the role he plays or even his name.

No doubt Cue has his hands full with the fast-growing App Store. When Apple rushed plans for the store into place in 2008, it was overwhelmed by the customer interest. The company had to invent the business on the fly, including how to approve and promote applications. Now Apple's back-end infrastructure may be as indispensable a competitive advantage as the iPhone's design. Developers have flocked to Apple because they see how the App Store can make huge successes of programs like Shazam and Tap Tap Revenge.

Apple's success has led to controversy. Some developers gripe about delays in getting into the App Store, and the Federal Communications Commission is investigating Apple's refusal to approve an application from Google. Analysts say Apple needs to develop better ways for customers to find just the right app among the thousands of options—and thereby make the business more profitable for more developers.

Still, most developers give Apple and Cue high marks. They not only established the App Store but also

are building on its success. "Apple is really listening to the marketplace," says Shervin Pishevar, CEO of app developer Social Gaming Network.

## **Enter Yahoo**

### **The company is out to become the go-to place for applications**

Yahoo! ([YHOO](#)) has big plans for apps. While Apple may have started the app phenomenon by letting developers create programs for the iPhone, Yahoo wants to be the company that brings apps to the wider world.

In the company's most ambitious app effort to date, Yahoo is redesigning its home page to include applications from outside developers. As the changes roll out through November, the apps will be listed along the left-hand side of the Yahoo.com page, used by more than 300 million people each month. Visitors can customize their own home pages, selecting the apps they want. Then they can check the day's headlines from USA Today or bid for an item on eBay ([EBAY](#)) without leaving the Yahoo site.

Yahoo will make money from advertising embedded within the apps. It's also considering launching its own app store, similar to Apple's, in which case it could charge for applications and split revenues with developers.

This is only one of the app frontiers Yahoo is exploring. The company has developed software for televisions that lets people launch applications such as Twitter and Facebook on the TV screen while watching their favorite shows. Another new technology allows people to tap into apps directly as they use Yahoo! Mail. Wherever people are, Yahoo wants to "summon up a gallery of all the possible things you could do," says Prabhakar Raghavan, head of Yahoo's research division. "Here are 50 million things you could do—book a ticket, upload a picture. Everything's an app."

Yahoo's home page strategy is getting some traction. Dozens of software developers have signed up and landed their programs in the "App Gallery," a menu from which users can pick and choose their favorite free programs. Carrie Cronkey, the director of business development at personal finance site Mint.com, says people are more likely to join Mint if they're referred by Yahoo because it implies a level of security. "The fact that [your app] is on Yahoo makes you more credible," she says.

For Yahoo, the real payoff from sprinkling apps into TVs and its home page comes in the form of data. By tracking which apps people use and how they interact with them, the company is building on its ability to serve targeted ads. That may help the company compete for ad revenues against rivals such as Google ([GOOG](#)). "Apps can play a big role in understanding user behavior," says Raghavan.

## **Gold Rush?**

### **Money is flowing into apps as smartphones reshape the tech world**

When Bart Decrem went looking for office space in the spring of 2008 for his startup, Tapulous, Jeff Clavier opened his door. Clavier, the founder of venture capital firm SoftTech VC, saw enormous potential in the Tapulous software that would run on Apple's iPhone. So he let Decrem use some space in the firm's Palo Alto (Calif.) digs and made an investment in his company.

Eighteen months later, Clavier's support of Tapulous looks like it may be one of his best investments ever. The company's Tap Tap Revenge app, in which players tap on-screen balls in sync to the beats of a song, has become a breakout hit. The game and its multiple spin-offs have been downloaded more than 15 million times. Tapulous, which makes money from game sales, advertising in the game, and the sale of in-game avatars, has been profitable since this summer, a speedy accomplishment for a tech

startup.

The investment has convinced Clavier there is loads of potential for venture capital investments in mobile applications. At last count, consumers had downloaded 2 billion programs from Apple's App Store, and that's just one place among several where people get apps. Clavier believes app startups could become billion-dollar outfits that rival traditional game and software companies. "The revenues of these companies will become substantial," he says. "There will be publishers that become large brand names."

### **"We See Huge Markets"**

The torrid growth has attracted money from other high-profile investors. Last March, Kleiner, Perkins, Caufield & Byers, one of the Valley's marquee venture capitalists, launched a \$100 million investment fund specifically to back startups creating software applications for the iPhone. Last October, Research In Motion ([RIMM](#)) unveiled a \$150 million venture fund, with investments from Thomson Reuters ([TRI](#)) and RBC Venture Partners, to develop apps and services for its BlackBerry and other phones. And this October, U.S. mobile operator Verizon Wireless ([VZ](#)) announced an initiative to invest up to \$1.3 billion in wireless applications and related technologies. "We see huge markets and game-changing opportunities," says Kevin Talbot, co-managing partner of the BlackBerry Partners Fund.

Of course, investors don't need a dedicated fund to participate. Firms such as Union Square Ventures, O'Reilly AlphaTech Ventures, and XG Ventures are devoting an increasing amount of time and money to financing wireless apps. "Most of the deals we see are in the mobile arena," says Andrea Zurek, co-founder of XG Ventures, a new VC firm of former Google ([GOOG](#)) executives.

The money flowing into apps is inspired by the belief that smartphones and other portable devices are transforming the tech world. The growth of mobile computing is sparking a renaissance in software development. Gaming apps are the most popular programs right now, but mobile shopping, content, social media, communications, and productivity tools are attracting increasing amounts of capital. "We don't think this is slowing down anytime soon," says Matt Murphy, the partner at Kleiner Perkins running the fund dedicated to Apple-related investments. (View an interview with Murphy here).

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