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GameStop (GME) 3Q Update

GameStop has all the signs of a company clearing the decks for a new CEO in its most recent earnings. Global sales rose, and it is calling for a lower tax rate, yet it is cutting guidance on EPS:

Guidance	Prior	New
Totals Sales	-2% to -6%	-2% to -6%
Comp Sales	Flat to -5%	Flat to -5%
Tax Rate	26% to 27%	23% to 24%
EPS	$3.00 to $3.35	$2.55 to $2.75
Cap Exp.	$110 to $120 mm	$100 to $110 mm

Working backwards, GME is essentially forecasting a margin decrease of about 100bp and it is seeing margin pressures in several areas such as new hardware, new software, and pre-owned products. Guidance for free cash flow was reduced from $300 million to $200 million due to inventory increases and setting a tax dispute.

The company had very few comments on the sale of Spring Mobile for $700 million. It did confirm that it would likely use the funds in a combination of retiring debt, repurchasing shares, and funding operations. It also pointed out that it will not be buying any shares until it completes its review of repositioning the company and hires a new CEO. The $155 million dividend could see improved coverage through a combination of fewer shares, lower interest expense, and reduced operating costs. We believe the company will experience a couple more quarters of write-offs and start some significant cost-cutting. The question is will they reduce the dividend? We think if it is going to happen, it would occur soon as part of the overall strategic review to right-size the company and the key is their view on future margin pressure:

- GameStop took $557 million in goodwill impairments in the quarter, which is far above the guidance provided in its filings

- Not much has radically changed since 2Q, in fact some sales trends improved, so the huge write-off looks like GME is trying to get as much bad news out as possible before the new CEO is hired

- Preowned sales continue to falter, and competition may be increasing, this could hurt the efforts to preserve customers and perhaps lead to inventory write-downs. As the biggest division, pressure in this unit has a large impact on results

- We expect more write-offs for leasehold improvements and PP&E as many stores are likely to close in efforts to reduce operating costs which could also mean more goodwill write-offs

- Another sign of clearing the decks – GME settled its tax issues with France in the quarter and paid approximately $30 million reducing forecasts for free cash flow

- By managing the decay by reducing expenses, GME should continue to produce solid cash flow. A path to growth may be difficult to achieve

GameStop's Write-Off Far Exceeds What Its Testing Guidelines State

The write-off for goodwill was $557.3 million in the 3Q18. There are two issues here. The bulk of the goodwill is in the US as the foreign goodwill has already experienced some sizeable write-downs in 2012. Results grew in the 3Q18:

	3Q18	3Q17
Sales	$2,084	$1,989
Gross Profit	$691	$689
SG&A	$567	$565
Depreciation	$30	$37
Op. Income	$94	$88

2017	U.S.	Canada	Australia	Europe	Tech
Goodwill	$1,160	$30	$74	$87	$317

Here is the discussion on this in the 10-K,

> *"Based on the results of our annual impairment test in fiscal 2017, the fair value of our United States reporting unit exceeded its respective carrying value by 13%. The fair values of our Canada, Australia and Europe reporting units exceeded their carrying values by 8%, 4% and 2%, respectively."*
>
> *"Variations in any of the assumptions used in the discounted cash flow analyses may arrive at different estimated fair values that could result in a material impairment charge. Assuming all other factors unchanged,* ***a 10% decrease in the projected net cash flows in each of our segments would result in impairment charges of approximately $5.0 million, $5.0 million, $20.0 million and $20.0 million in our United States, Australia, Europe and Technology Brands segments****, respectively. Alternatively, assuming all other factors unchanged,* ***an increase of 100 basis points to the discount rates utilized in the tests of each our segments would result in an additional impairment charge of approximately $3.0 million in Technology Brands, with no impairment charges in the Video Game Brands segments. Sustained declines in our stock price and related market capitalization could impact key assumptions and the estimated fair values of our reporting units that could result in material goodwill impairment charges.*** *We can provide no assurance that we will not have impairment charges in future periods as a result of changes in our operating results, our assumptions or in our stock price."*

There is considerable leeway for management judgment to impact the valuation of goodwill. It seems odd to us that a 10% decline in projected US Video Game cash flows would only result in a $5 million impairment, a 100bp increase in the discount rate would have no impairment, and there was no impairment taken in the first half of 2018 when operating income fell from $145 million to $79 million and the company affirmed guidance. Furthermore, the company announced the sale of its weaker segment after 3Q, this could have been a big part of the reason for the write-down as the technology brands unit had $317 million in goodwill prior to the sale.

However, the company only listed the cause as the decline in the stock price. The stock price has been falling since 2013 from $55 to end 2017 at under $17. There was no market cap driven impairment taken during that time. The stock was $12 in 1Q18 and has been hovering between $13-$15 since. Arguably, having the market cap fall below $1.38 billion vs. about $1.35 billion in goodwill could play a role. In our view, some of this write-down was due to management trying to improve the balance sheet and take a large enough hit to goodwill to prevent further write-downs.

It looks more like what most people call a "Big Bath" charge to get past being close to the edge and not having to recognize a series of smaller "one-time" charges. This may remove much of the goodwill from the technology brands unit ahead of the sale of Spring Mobile.

Preowned Sales May Not Recover

Historically, this has been a material part of the business as the largest percentage of gross profit:

	3Qs 18	3Qs 17	2017	2016	2015
Pre-Owned Sales	$1,345	$1487	$2,150	$2,254	$2,375
Pre-Owned Gross	$589	$679	$977	$1,044	$1,115
Margin	43.8%	45.7%	45.4%	46.3%	46.9%

Gross Margin	3Qs 18	3Qs17	2017	2016	2015
New Hardware	$106	$102	$163	$154	$176
New Software	$326	$351	$590	$600	$689
Pre-Owned	$589	$679	$977	$1,044	$1,115
Accessories	$195	$152	$255	$235	$255
Digital	$117	$108	$162	$155	$150
Collectibles	$144	$131	$208	$172	$117

The company points out that some of the variability of pre-owned results stem from the timing of new release hardware and software. People trade in equipment and games to buy new items. So, when new releases are few or are not well-received – the trade in market goes down. Also, there is a lag for trading-in too because the bulk of the new games and hardware are not sold immediately. So, a new hit game may sell well for 3-4 quarters, but that may break down into a modest 1Q due to lack of supply early on, higher 2Q, and then peak in 3Q. That game won't be traded back in big volumes for perhaps 3-5 more quarters. **The company noted on the earnings call that the trade-in cycle seems to be extending as people hold physical games longer.**

However, the decline has been steady with accelerations in periods such as 2018. We think the changing rates of speed are due more to the timing of trade-ins and the availability of new games. But there are also more competitive options taking market share. GME has warned it faces a risk from people buying more games digitally. Those do not get traded back in and reduces the size of the overall market for future pre-owned sales.

In the 3Q18, the company also warned that there are more options to buy older games online. Current CEO Shane Kim noted,

> *"We are seeing more of an impact of that [digital access to older games] in recent months and it does have to do with how customers can get some of those older titles, the very inexpensive titles that you can get through either subscription memberships or online in a pretty heavily discounted mode."*

The problem is the operating model relies heavily on buying back older games and equipment at a discount for store credit used to buy a new game. GME ends up acquiring inventory for a high margin area and hopes to create a new sale in the future when the current new game is traded back. Digital sales are cutting the volume of trade-in games. Also, customers can find older games online at lower prices.

This area is not going to vanish immediately, but we believe it will face lower sales and weaker margins if it is forced to reduce prices. GME is making margins of 10%-12% on new hardware and 22%-24% on new software. So, with margins on the pre-owned gear at over 40%, they will trade some margin points to boost sales. But there is a worse situation that may be building – what if the volume of used gear is declining and growing unit sales in this area simply isn't a realistic option? Then, they just make less profit on each unit and the decay in this area continues.

It is possible that there are some write-downs here if the value of the used software is being pushed down by competition at this point, it doesn't appear that GME is cutting prices. Rob Lloyd the CFO reported this saying fewer promotions were offered to customers in 3Q,

> *"Our pre-owned business declined 13.4% in the quarter. We continued to see declines in pre-owned software, reflective of fewer title launches and a decline in physical software sales earlier in 2018, which affects inventory levels, weakening demand in the face of digital adoption, including digital access to older titles and fewer promotions offered to our customers in the quarter. We experienced growth in the pre-owned hardware category."*

More Write-Downs Possible in PP&E as Stores are Closed

Comp sales have been weak for GME for some time and they are very seasonal with Christmas being a key time for video game sales. When the company announced a $205 million increase in inventory – about $70 million more than last year as they accelerated purchases of new games launched earlier than last year – we were not concerned as that is seasonal and they should sell it all. But that doesn't change that comps remain slow:

Store comps	3Q18	2Q18	1Q18	4Q17	2017	2016	2015
US Stores	3.4%	2.4%	-2.6%	14.2%	4.3%	-13.5%	4.8%
Intl. Stores	-0.5%	-6.4%	-11.6%	8.3%	9.2%	-4.4%	3.0%

The great 4Q17 figures were helped by adding a 14^{th} week in the period and that helped 2017 results as well.

The company has flexibility. With repeat customers who have store credit and growth in online sales – people are likely to still seek out another GameStop store if their primary location is closed. We discussed reverse cannibalization in early reports on GameStop, where comp sales rise at remaining stores because sales from the closed stores migrate to the remaining ones. This company is really set up for that.

The average lease remaining on Video Game stores is under two-years. That allows them to exit stores more easily with minimal cost. We expect that after Christmas, many stores will start to be closed. Ultimately between reduced rent expense and wages – we would not be surprised if GME can pull at least $200 million in cost out of the business model. Rent expense last year was $442 million, which included the Spring Mobile division. There were 22,000 full time employees and 25,000-45,000 part-time employees which changes based on seasonality of the business.

There will be more write-offs though. Most of PP&E is buildings, leasehold improvements, fixtures and equipment. The net figure here was just under $400 million at the end of 3Q18. Getting rid of Spring Mobile will lower that and then if GME announces 500-800 store closings over the next two years – a large percentage of that will be written off.

GameStop Settled with France on Taxes

We think this is again another piece of getting more bad news behind them. This issue regarding taxes from 2008-15, was being "vigorous contested" and our position is strong and we "have not taken a reserve" in the March 22, 2018 10-K. Then a $30 million reserve was taken, and in the 3Q18, the company paid the $30 million to settle the matter.

One of the reasons the free cash flow forecast was cut from $300 million to $200 million for fiscal 2018 is the higher inventory and this tax payment.

Timing and Conclusion

The Spring Mobile sale of $700 million is expected to close in the current quarter. As we noted last week, we think that cash is likely to pay off the $350 million of 5.5% senior notes due in October. The company cannot buy back shares until it completes its strategic review and likely cannot buy shares until it hires a new CEO and discloses that information.

We are picking on some of the huge write-offs here as being a "big-bath" charge to avoid more charges going forward. However, those are non-cash events other than paying the $30 million in French taxes. Writing off PP&E from closing stores will not consume cash.

Many signs point to some sizeable store closings coming in 2019 and 2020. There may be some cash costs there to deal with employees and closing out leases. However, there is unlikely to be many buyouts of leases given that half the leases expire within two years.

Margins are declining at GME and sales growth has been poor. However, taken as a whole, gross profit is not falling as fast as pre-owned games because digital and collectibles are seeing gains:

	3Qs 18	3Qs 17	2017	2016	2015
Gross Profit	$1,477	$1,523	$2,355	$2,360	$2,502
change	-$46		-$5	-$142	

The company is likely to lose sales to competition if it closes stores and there may be pressure on pricing. That could hurt gross margins further. As noted above, the company is forecasting about 100bp of margin compression in its new guidance. Leaving out the sales and profit of the technology brands (as much of that will be sold) and other – fiscal 2017, sales were $8.1 billion and gross profit $2.35 billion for a 29.0% gross profit margin. On top of this, there remains about $90 million from loyalty programs and there will still be some gross profit from the Apple tech stores.

Paying off the 5.5% notes will save $19.25 million per year. Closing enough stores over two years to save $200 million or more in rent and wages is probably understating how much the company is planning. If they buy 10 million shares for $15, it saves about $19 million pretax in annual dividends. Adding all that up net of taxes, cash needs could fall here about $190 million annually. Also, capital spending was forecast at $110-$120 million before the Spring Mobile sale. Selling that unit and closing many Video Game stores will probably cut capital spending to $50 million – so another $50 million in cash would be saved annually.

The dividend going forward would be $140 million per year and $475 million in bonds due in 2021 would still be outstanding. There would be $200 million in additional cash on hand from the Spring Mobile sale.

The problem is losing 1% of sales costs the company about $23 million in gross profit. Losing 100bp of gross margin costs about $80 million in gross profit. Closing stores and potentially lower selling prices from competitors should lead to lower sales. A 5% drop is $115 million in lost gross profit. It doesn't take a very aggressive prediction of margin reduction and lost sales to see gross profit fall $400 million (10%-12% lower sales and 150bp of lost margin during the transition). That could offset the cost savings.

The current situation points to the dividend having a decent cushion, $300 million if free cash flow vs. $155 million in dividend payments. We will treat the inventory build and French tax payment as one-time events and add that back to the $200 million forecast. Plus, the capital spending figure could fall by $50 million going forward. Cost cutting is coming, cash levels are rising, which is all positive. However, the company is looking at margin pressure and will likely lose sales by closing stores. As it clears the deck for a new CEO by writing off assets, laying out a restructuring, and selling a large division – the dividend could be cut to $0.80 and save $75 million in cash annually with the yield still at 6%. The goal is getting the bad news behind them. If the board is forecasting more margin pressure as they complete the strategic review, they likely are looking at the dividend too. Our belief is the strategic review needs to result in at least $350 million in annual cash savings to offset margin and sales pressure to maintain the dividend long-term. Moreover, the company also needs have a growth plan for the future. Managing decay seldom results in high valuation multiples and the dividend is what holds up the stock price.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
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2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
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