BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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GameStop (GME) – Dropping Coverage

We are eliminating coverage on GameStop (GME) with the stock in the $5s, new management being appointed, and the elimination of the dividend after an ugly first quarter. It also does not appear that there are any concrete plans on what to do with the business:

- After selling the phone stores, closing some stores, and launching a cost-cutting program – the company is now doing a reboot to look at all aspects of the business.

- A Blockbuster Video Store problem has been highlighted at GME where 20% of SKUs drive 80% of sales. (Blockbuster had the back wall of new release movies that generated almost all the business in a store full of older movies that were often ignored.

- A new transformation process has been launched to cut more costs and test ways to restock/arrange stores, changing pricing, and hiring a tier-one consulting group to examine the business. This sounds like step 1 for a company that has been restructuring for several years now.

- After eliminating the dividend because GME noted, "*we are confident that redirecting capital towards debt reduction and reserving capital for successful transformation initiatives will put us in a better position to drive increased shareholder value over the long term.*" -- the company announced a 12 million share repurchase program only one-week later.

- The first quarter call had nearly every pep-talk cliché that said - "We're excited but don't know what we're going to do." For example, "*We're up to the challenge,*" "*Associates across the organization want to win,*" "*we can execute better,*" "*we'll be* *deliberate and act with urgency," "we've shown the commitment to being laser-focused on the core elements of our business…"*

- However, the call also noted that other than divesting the Simply Mac unit – they haven't determined how to answer the problems reporting that it needs to: *"develop new revenue streams," "we need a cohesive pricing strategy," "GameStop needs to be there [in digital games] and I'm committed to ensuring that we will be."* They like the real estate and flexibility – all they need is something new to sell.

We have highlighted that the used video game market is in decay for GME because more people are buying downloads of games rather than physical products. There is also a cyclical lag from new sales to used sales that impacts the used market. After several quarters of weak sales (4 of the last 5 quarters)– we expect the used market to remain under pressure until a few quarters after the release of new game platforms by suppliers. This is ultimate problem. The margins here are much larger than other parts of the business and it locks in future sales because people sell used products for discounts on store merchandise. We noted recently that older games are also available on-line for lower prices from competitors, which saps demand for GME's used inventory. Also, it's another place where digital games are taking business from physical games.

The company still isn't broke – it has $543 million in cash and has retired a considerable amount of debt. Fixed debt is less than cash. Leases are the remaining part of debt with a two-year average life. We would expect it to close more stores as leases expire if it is going to build out more on the digital side. That would reduce costs and lease liabilities. One of the new executives worked at Best Buy for digital merchandising and gaming. Some sort of tie-up with Best Buy or having Nintendo, Sony, Microsoft use GME stores to show-case new products may be where this story is heading.

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
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently 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.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

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