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# GameStop Corp. (GME) EQ Review

| Current EQ Rating* | Previous EQ Rating |
|---|---|
| 3- | NA |

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

### We initiate coverage of GameStop Corp. (GME) with a rating of 3- (Minor Concern)

GME primarily sells video games, gaming hardware, and accessories. It is in the middle of a battle with short-sellers who have driven the short interest to over 40% on the belief that the business is in decay, increased management turnover, and some awful results as its attempt to diversify into being a reseller for AT&T. The bulls are looking at a hefty dividend, a low valuation, and the potential for the company to be sold.

In general, we prefer to avoid heavily shorted names as the volatility can be immense and often happens with little rhyme or reason. We thought we would look for accounting reasons to support one side or the other. We found reasons to question future growth further as the accounts such as customer liability accruals are falling over time which runs counter to GameStop's business model of keeping customers coming back with a way to trade back old games and equipment to offset the purchase price of new gear. The acquisition results have indeed become ugly quickly. A company with a market cap of $1.6 billion has probably lost $500 million on an investment that had a low ROI from the outset. We also think some of the highlighted figures like comp-store sales growth are inflated due to changes in store count and adding additional merchandise to the figures.

If you are a bull – the cash flow is in decay but can support the dividend yielding 9.5% for the time being but not forever unless the business turns around. Capital spending should

decline too and paring back the store base footprint should save expenses. The accounting in most areas is conservative, but some of the changes in presentation are not.

- The comp sales are growing, but they are redefined every few years as to the composition. They are also benefiting from closing lagging stores and a 53rd week last year. The overall sales trend is decidedly negative, and it does not take too many adjustments such as backing out T-shirt sales and treating closed store sales being captured at remaining stores as simply a new base level of sales instead of actual growth to see comps aren't strong either.

- The company generates future sales via giving trade credit to customers who want to swap old games and equipment for new merchandise. The related customer accruals are going down, which is not a good sign for future sales.

- Trends in sales and profits for pre-owned merchandise are falling and the digital side is not offsetting that. Loyalty program growth appears to be slowing and the paid-membership has stalled.

- Marketing overall is declining and become two headwinds. Vendors give GME trade credit to support brands and product rollout which reduces GME's Cost of Goods Sold. Trade credit has been falling noticeably for years and hurts income. GME has responded by boosting its own marketing, which hasn't offset the vendor credit drop and also reduces income.

- Diversification efforts into AT&T phone plans and doing Apple repairs and sales have been awful. The best ROI we can impute was about 9% for one year of the 3.5 years GME has been involved here. They have already written off about half their investment and comp trends remain negative.

- Recent accounting changes are minor and added 1-cent to EPS in the first half of 2018.

## The Basic Story

GameStop is giving guidance for cash flow of about $420 million with capital spending in the $110-$120 million range focusing on remodels for stores. That will give it $300 million in free cash flow against a dividend of $155 million. We are not going to focus too much on the first half of 2018 as the business is very seasonal. However, there may be some pressure on that $420 million forecast.

| | 1H18 | 1H17 | F2017 | F2016 | F2015 |
|---|---|---|---|---|---|
| Cash Ops | -$429.9 | -$311.7 | $434.9 | $537.1 | $656.8 |
| CapX | $40.1 | $47.2 | $113.4 | $142.7 | $173.2 |
| Acquisitions | $0.0 | $8.5 | $8.5 | $441.2 | $267.5 |
| Free Cash Flow | -$470.0 | -$367.4 | $313.0 | -$46.8 | $216.1 |
| Dividend | $79.9 | $78.2 | $155.2 | $155.5 | $154.1 |
| repurchase | $0.0 | $22.0 | $22.0 | $63.1 | $194.3 |

The company has stopped buying shares and plans to devote some of the remaining free cash flow toward debt repayment. There is cushion here between forecasts of $300 million in free cash flow and $155 million in dividends. But, the decay needs to slow to justify keeping the dividend where it is.

## Comp Sales Defined and Redefined

Most retailers define same-store sales or comps as y/y gain in sales for stores open over 12 months the year before. The sales occur in the store. GameStop does it differently. First, its tech stores that sell AT&T products, wireless and satellite plans along with Simply Mac stores selling Apple products and repairs are viewed via Gross Profit per Store, not Revenues. We will talk about that more later. Second, the Video Game stores add several other areas that are not always part of Same-Store Sales such as web-based sales and sales of product that is wholesaled out to other dealers. Moreover, the definition of comparable-store sales has changed over the years:

> ***From the fiscal 2016 10-K*** *– "Our comparable store sales are comprised of sales from our Video Game Brands stores, i**including stand-alone collectible stores**, operating for at least 12 full months as well as sales related to our websites and sales we earn from sales of pre-owned merchandise to wholesalers or dealers. Comparable store sales for*

*our international operating segments exclude the effect of changes in foreign currency exchange rates."*

***From the fiscal 2012 10-K*** *– "Our comparable store sales is comprised of sales from stores operating for at least 12 full months as well as* ***sales related to our Web sites and sales we earn from sales of pre-owned merchandise to wholesalers or dealers****. Comparable store sales for our international operating segments exclude the effect of changes in foreign currency exchange rates."*

***Fiscal 2011 10-K*** *– "Stores are included in our comparable store sales base beginning in the 13th month of operation."*

The issue is these new areas have become a larger area of sales, especially collectibles. Sales peaked in the Video Game business at $9.55 billion in fiscal 2011. Collectibles are essentially T-shirts, bobbleheads and other trinkets related to movies. Much of that type of stuff is available in numerous catalogs, online retailers, and other stores like Target. This is supposed to be the dominant video game software and equipment retailer, but it has modified components of sales to include T-shirts to help improve operations.

| | 1H18 | F2017 | F2016 | F2015 | F2014 |
|---|---|---|---|---|---|
| Video Game Sales | $3,243 | $8,421 | $7,794 | $8,830 | $8,967 |
| Collectibles | $284 | $636 | $494 | $310 | $76 |
| Digital | $83 | $189 | $181 | $188 | $216 |
| Collectible % | 8.8% | 7.6% | 6.3% | 0.4% | 0.8% |
| Digital % | 2.6% | 2.2% | 2.3% | 2.1% | 2.4% |

Give GME some credit for adapting to something new. However, stripping collectibles out last year, sales at video games is $7.79 billion and are down 18% from the peak. But, GME is reporting positive comp sales in most years:

| | 1H18 | F2017 | F2016 | F2015 | F2014 | F2013 |
|---|---|---|---|---|---|---|
| Comp Sales | -3.2% | 5.8% | -11.0% | 4.3% | 3.4% | 3.8% |
| US Comps | -0.5% | 4.3% | -13.5% | 4.8% | 2.5% | 3.0% |
| Store Count | 5,856 | 5,899 | 6,013 | 6,081 | 6,206 | 6,457 |
| US Store Count | 3,840 | 3,864 | 3,944 | 4,013 | 4,138 | 4,249 |

Looking at the comps two things jump out. First, in Fiscal 2017 there were 53 weeks in the year. Total sales for the Video Game unit were up $627.1 million. Of that total, $104.6 was due to positive FX last year and GameStop excludes FX from comp sale calculations so a net

gain of $522.5 million before FX. The 53rd week added $130.9 million to sales or 25% of the total. **We estimate that the 5.8% comp would have risen about 4.4% after the -11.0% year before without a 53rd week.** Collectible sales were up $142 million also. That could be as much as another 1.4% of the comp.

The other big issue is reverse cannibalization of closing stores. GME has been closing stores for years and the store count is falling both in the US and Internationally. When there are multiple stores in the same city, closing one doesn't necessarily mean that all the sales are lost. Especially with a specialty store like GameStop, many of the closed store's sales transfer to other stores that are still open. This shows up as Comp Sales growth, but in reality, it is simply resetting the base sales of the store that is still open to a higher level. To make it easy, think of a store that has 10 customers who all spend $5 or $50 in base sales. If another store closes and an 11th customer moves over and makes the first store his primary location, then now it's a store with 11 customers spending $5 or $55. It shows up as 10% sales growth in the first year and then goes to 0% the next unless people boost spending.

| | F2017 | F2016 | F2015 | F2014 |
|---|---|---|---|---|
| Video Game Sales | $8,421 | $7,794 | $8,830 | $8,967 |
| Store Count | 5,899 | 6,013 | 6,081 | 6,206 |
| Sale/Current Store | $1,428 | $1,296 | $1,452 | $1,445 |
| Sales/Prior Yr Store | $1,400 | $1,282 | $1,423 | $1,389 |
| Comp gain | 1.9% | 1.1% | 2.1% | 4.0% |

This would not take into account stores that were open less than 12 months, so these numbers should be used as an indication of the impact and not an exact figure. We simply took the video game sales in one year and divided by the ending store count in that same year and also the preceding year. The smaller store count would give a larger figure for sales per store than the prior year. By dividing the two figures you can see some indication of comp sales gain by shrinking the store base.

We see this as a company that is already reporting declining sales from its main business. The comp sales growth is generally positive at about 3% per year. However, adding non-core products to the mix is over 1%, a 53rd week another 1% plus, and reverse cannibalization about 2% more. The reported comps are masking the overall sales decline as a result of these presentation issues in our view.

## Trends in Pre-Owned Inventory and Loyalty Programs Are Weakening

GameStop has an interesting operating model whereby customers can sell older video game equipment and games to a GameStop store and receive store credit. That store credit can be used to buy new games and equipment from GameStop. The accounting model itself is conservative in that it records the value of the inventory purchased at the price of store credit given. There is an inventory reserve of about 4% for all inventories, which we believe would have a higher weighting toward the pre-owned inventory for obsolescence and potential markdowns that happen when some of this inventory is sold to wholesalers. The idea is GameStop can entice repeat business from customers by helping them trade.

Also, the store credit becomes a customer liability account and only becomes a source of revenue when it is redeemed or considered breakage – or unlikely to be redeemed. This again is a conservative model.

The biggest risk to keeping the model going is customers downloading games rather than buying them as physical software discs. GameStop warns of this:

> *"The current consoles from Sony, Nintendo, and Microsoft have facilitated download technology. Downloading of video game content to the current generation video game systems continues to grow and take an increasing percentage of new video game sales. If consumers' preference for downloading video game content continues to increase or these consoles and other advances in technology continue to expand our customers' ability to access and download the current format of video games and incremental content for their games through these and other sources, our customers may no longer choose to purchase video games in our stores or reduce their purchases in favor of other forms of game delivery. As a result, our business and results of operations may be negatively impacted."*

The problems we see is much of this appears to be slowing down:

| | F2017 | F2016 | F2015 | F2014 | F2013 | F2012 |
|---|---|---|---|---|---|---|
| Inventory Turnover | 4.6 | 4.5 | 5.2 | 5.7 | 5.3 | 5.0 |
| Customer Liabilities | $302 | $343 | $342 | $364 | $369 | $363 |
| Sales of Preowned | $2,150 | $2,254 | $2,375 | $2,389 | $2,330 | $2,431 |
| Gross Profit Preowned | $977 | $1,044 | $1,115 | $1,146 | $1,094 | $1,170 |
| Sales of Digital | $189 | $181 | $188 | $216 | $218 | $208 |
| Gross Profit Digital | $162 | $156 | $150 | $152 | $149 | $121 |

Inventory turnover is going to include all forms of inventory, both new and used. But that is clearly slowing and becomes an area that consumes cash. The customer liabilities are store credit, loyalty points, and gift cards. We would like to see that rising as it indicates future sales. It dropped noticeably last year. Sales and profit on preowned equipment have dropped as well – profits down about $200 million over time and the digital sales are not replacing that.

The company's sales are highly seasonal, so we don't want to read too much into YTD figures, but nearly everything has worsened further. For example, sales are down 4.1%, while inventory rose 8.5%. Total accrued liabilities fell from $856 million to $681 million y/y. They are not broken down into customer liabilities which are normally about 30%-35% of the total accrual. If the total is down $175 million (there was an accounting change that contributed about $14 million to the decline) – some of that drop should be customer liabilities too.

| | 1H18 | 1H17 |
|---|---|---|
| Sales of Preowned | $2,150 | $2,254 |
| Gross Profit Preowned | $977 | $1,044 |
| Sales of Digital | $189 | $181 |
| Gross Profit Digital | $162 | $156 |

The company's reason behind much of this is to get customers to trade in old games to buy new games, but the commentary sounds like that cycle is slowing:

> ***1H 2018 sales note*** – "Pre-owned and value video game product sales decreased $80.2 million, or 7.8%, for the 26 weeks ended August 4, 2018 compared to the 26 weeks ended July 29, 2017, primarily due to weaker new title releases. "
>
> ***2017 sales note*** – The increases (in sales) described above were partially offset by a decrease in pre-owned and value video game product sales of $104.5 million, or 4.6%, for fiscal 2017 as compared to fiscal 2016, primarily due to the decrease in store traffic as a result of weaker new release titles mainly in the first half of the current fiscal year. "
>
> ***2016 sales note*** – "Pre-owned and value video game product sales decreased $120.6 million, or 5.1%, for fiscal 2016 as compared to fiscal 2015, primarily due to the

decrease in store traffic as a result of weaker new release titles and hardware unit sales declines in the current year."

GameStop runs a loyalty program called *PowerUp* which gives points and other perks. There is a paid version for $14.99 per year that includes a free subscription to GameStop's magazine *Game Informer*. The ones that pay the fee get additional discounts on merchandise as well. In recent years, the number of people in the US joining the free *PowerUp* is starting to slow and the paid memberships have declined:

| in millions | F017 | F2016 | F2015 | F2014 | F2013 |
|---|---|---|---|---|---|
| Free PowerUp US | 37.0 | 36.0 | 33.0 | 30.0 | 27.0 |
| Paid US PowerUp | 6.3 | 6.0 | 6.0 | 7.0 | 7.0 |

The 6.3 million may not be an increase. In prior years the disclosure is "approximately 6 or 7 million." In either event, the growth rate of total customers is slowing and the percentage paying for the premium version is falling. This is another potential for a problem. $15 per year for 6 million customers is $90 million in operating income and cash flow every year for GameStop.

| | F017 | F2016 | F2015 |
|---|---|---|---|
| Operating Earnings | $526.4 | $591.5 | $652.8 |
| Cash Flow Ops | $434.9 | $537.1 | $656.8 |

That $90 million that is not growing and may be under some pressure is 15%-20% of cash flow and earnings. We do not see that going to zero by any stretch, but it appears the trade-up cycle that GME supports via customer loyalty programs and points is under pressure from digital downloads. Losing some of this money could become a headwind for earnings also.

## Marketing Overall Is Declining

GameStop pays for advertising on its own. It also receives vendor allowances from Sony, Nintendo, and AT&T among others to pay for brand/product support. These allowances are treated as a reduction to inventory costs and thus lower Cost of Goods Sold. Overall spending has been falling from its suppliers and GameStop has not fully matched that decrease with its own rising advertising:

| | F017 | F2016 | F2015 | F2014 | F2013 |
|---|---|---|---|---|---|
| Vendor Allowances | 162.5 | 184.3 | 208.2 | 202.4 | 221.0 |
| GS Advertising | 83.3 | 76.6 | 66.6 | 64.1 | 57.8 |
| Total Spend | 245.8 | 260.9 | 274.8 | 266.5 | 278.8 |

For GameStop, this means it is hurting EPS by spending more of its cash flow, and the lower spending by vendors is effectively lowering its gross margin. In rough terms, $10 million in higher advertising costs GameStop about 5-6 cents in EPS. At the same time, $10 million in lower vendor allowances does the same thing by cutting gross profit and netting out to 5-6 cents in lower EPS. This appears to be a likely EPS headwind.

## The Acquisitions Have Been Producing Charges

GameStop could see some of the slowdown in video games and rise of online content too. The company started to diversify into new areas such as selling and servicing Apple products and AT&T wireless stores. This set off a big surge in capital spending and acquisitions with cash flow:

| | F2017 | F2016 | F2015 | F2014 | F2013 |
|---|---|---|---|---|---|
| Cash Flow Ops | $434.9 | $537.1 | $656.8 | $480.5 | $762.7 |
| Capital Spending | $113.4 | $142.7 | $173.2 | $159.6 | $125.6 |
| Acquisitions | $8.5 | $441.2 | $267.5 | $89.7 | $77.4 |
| Free Cash Flow | $313.0 | -$46.8 | $216.1 | $231.2 | $559.7 |
| Tech Stores | 1,377 | 1,522 | 1,036 | 484 | 218 |
| Video Game Stores | 5,899 | 6,013 | 6,081 | 6,206 | 6,457 |

As can be seen already, these stores are starting to be closed and sold. The current store count is 1,336.

| | 1H18 | F2017 | F2016 | F2015 | F2014 |
|---|---|---|---|---|---|
| Comp Gross Profit/Store | -4.4% | -13.1% | n/a | n/a | n/a |
| Op. Income | $30.1 | -$315.7 | $44.2 | $27.0 | $32.9 |
| closing cost | $0.0 | $0.0 | $19.8 | $0.0 | $0.0 |
| Impairments | $0.0 | $388.1 | $23.6 | $0.0 | $0.0 |
| Adj Op. Income | $30.1 | $72.4 | $87.6 | $27.0 | $32.9 |

Because of the changing tech and price points, GME likes to view the tech stores on a comparable gross profit per store basis. That has not been positive. They invested $884 million via acquisitions in this area and within 3 years wrote off $431 million of that amount. Capital spending also was devoted to these stores. Even if we are kind and estimate that the total spending here was only $1 billion, the best ROI before impairments was less than 9%.

In the world of Apple iPhones and Macs, they went from 76 Simply Mac stores to 48. They sold the Cricket stores and are closing AT&T stores. Some of the rationale given is poor store traffic, dealer agreements that were lower, and changes in commission income.

The company cheered that it negotiated a higher commission on mobile transactions with AT&T that started on April 1 and higher compensation in higher cost markets on July 1. The gross profit per store figure is still falling and that is after removing less profitable stores.

Maybe, this can improve. But from accounting review standpoint, this investment went sour very rapidly and was never that great at producing a decent ROI. The charge-offs were material and this operation is not offsetting some of the decay in the existing business. They have owned this as AT&T has grown and Apple has rolled out multiple new iPhones.

## Other Accounting Issues:

In adopting ASU-2014-19 relating to contracts with customers, GameStop made changes that impact its loyalty cards and gift cards. Historically, the company would defer the amounts under these accounts and record them as revenue when the customer made a transaction. Now, the loyalty points will be allocated to specific products and deferred revenue. The gift cards will still be deferred revenue until redeemed, but instead of waiting until after two years to assume the cards will not be redeemed and considered breakage, GME will now assume breakage occurs every quarter at historic rates on gift cards. The net impact to accrued liabilities was a reduction of only $13.7 million. That is why we are not looking at this as a reason for the decay in loyalty programs discussed earlier.

The net impact on income from these changes of accelerating some revenues and costs was $1.4 million for the first half of 2018 or basically just over 1-cent.

GameStop is still fully evaluating the new tax law changes. It has foreign operations but does not intend to repatriate all the cash. There is a dispute of 80 million Euros over taxes in France. We have no additional insight into that matter. GameStop took a reserve of $29.6 million in 2018 for this issue. It represents a material issue and cash payment if resolved unfavorably.

# Explanation of EQ Rating Scale

| Rating | Explanation |
|---|---|
| 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 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. |
| 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.

**Key Points to Understand About the EQ Score**

**The EQ Review Rating is much more than a blind, quantitative scoring method**. While we utilize proprietary adjustments, ratios and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

**The EQ Review Rating is not comparable to a traditional buy/sell rating**. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy, but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

# Disclosure

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