BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Kraft Heinz (KHC) EQ Review

Current EQ Rating*	Previous EQ Rating
2+	NA

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

We initiate coverage of Kraft Heinz Corporation (KHC) with a rating of 2+ (Weak.)

We have several items of concern with KHC's recent results:

- KHC has maintained a receivables securitization program for several years. In the second quarter, it unwound the US portion of the program. After adjusting for the sold receivables, accounts receivable days sales have been rising by 1-2 days over the last few quarters. This is not overly concerning.

- However, in November of 2017, the company had to restate its 10-Qs for the 3/17 and 6/17 quarters for failing to properly account for cash flows from receivables securitizations under ASU 2016-15 which it had adopted in the 3/17 quarter. This

also led to the company identifying a material weakness in internal control over financial reporting.

- Operating cash flow growth adjusted to include payments on previously securitized receivables currently classified as investing cash flows is stronger than what is implied by reported operating cash flow. However, the adjusted figure is being boosted by the accelerated collection of these retained interests in receivables. This should normalize after the next two quarters.

- Operating cash flow has received a significant boost from an increase in accounts payable for the last several quarters. However, the pace of the increase is slowing, and the company has indicated that terms with its suppliers are becoming less favorable.

- Even after adjusting for a one-time pension contribution, the dividend still consumes approximately 80% of free cash flow on a trailing 12-month basis. With net debt-to-EBITDA already approaching 4x, we see little room for dividend growth.

- The allowance for bad debts as a percentage of trade receivables fell to 1.2% from 3.0% a year ago. We estimate it would have taken an additional 1.2 cents per share in provision expenses to have kept the allowance flat with the previous quarter.

- KHC has taken over $2 billion in charges since 2015 related to the integration of Heinz along with maintaining several other restructuring programs simultaneously. While integration charges related to a deal the size of Heinz are understandable, we will be concerned if the charges continue to roll in. In addition, the quarter contained $265 million in impairment charges to goodwill and intangibles related to struggling reporting units and brands, and the company identified that several units have goodwill and intangible balances with fair values that are less than 10% of carrying value.

Receivables Securitization Unwind

Like many companies we have reviewed, KHC has been utilizing an accounts receivable securitization facility to accelerate cash collections from sales. Under the program, accounts receivable are transferred to a wholly-owned special purpose finance subsidiary which then

securitizes and sells those receivables to third-party banks. KHC receives consideration in the form of cash and a retained beneficial interests in the outstanding receivables. In addition, the receivables are deconsolidated from KHC's balance sheet at the time of sale. The company describes its securitization program as follows in its most recent 10-Q filing:

> *"We utilize accounts receivable securitization and factoring programs (the "Programs") globally for our working capital needs and to provide efficient liquidity. We operate these Programs such that we generally utilize the majority of the available aggregate cash consideration limits. We account for transfers of receivables pursuant to the Programs as a sale and remove them from our condensed consolidated balance sheets. Under the Programs, we generally receive cash consideration up to a certain limit and record a non-cash exchange for sold receivables for the remainder of the purchase price. We maintain a "beneficial interest," or a right to collect cash, in the sold receivables. Cash receipts from the payments on sold receivables (which are cash receipts on the underlying trade receivables that have already been securitized in these Programs) are classified as investing activities and presented as cash receipts on sold receivables on our condensed consolidated statements of cash flows."*

Therefore, to analyze trends in receivables, one must add the securitized receivables that have not been collected yet back to the trade receivables account on the balance sheet. The following table shows balances related to trade receivables and the associated securitized balances:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Trade Receivables	$1,950	$1,044	$921	$938
Reclassified as "Sold Receivables"	$37	$530	$353	$427
Receivables Exchanged for Cash	$162	$659	$673	$673
Adjusted Receivables	$2,149	$2,233	$1,947	$2,038
Sales	$6,686	$6,304	$6,957	$6,314
Adjusted DSOs	29.3	32.3	25.5	29.5

	7/1/2017	4/1/2017	12/31/2016	10/02/2016
Trade Receivables	$913	$886	$769	$855
Reclassified as "Sold Receivables"	$521	$588	$129	$208
Receivables Exchanged for Cash	$579	$612	$871	$694
Adjusted Receivables	$2,013	$2,086	$1,769	$1,757
Sales	$6,637	$6,324	$6,857	$6,267
Adjusted DSOs	27.7	30.1	23.5	25.6

"Trade receivables" amounts are the balances shown on the company's balance sheet representing receivables that have yet to be securitized. The "Sold Receivables" amounts are also disclosed as a separate line on the balance sheet and represent the retained interest in receivables that have been securitized and reclassified but remain on the balance sheet. "Receivables Exchanged for Cash" are securitized receivables for which the company received cash, but the sold receivables have yet to be collected from the customer. These amounts must all be added together to arrive at an adjusted accounts receivable balance which we use to calculate an adjusted account receivable days of sales (DSO). We can see from the table that DSOs have been rising around 1-2 days on a year-over-year basis for the last few quarters. This is not an alarming increase, and we observe that adjusted DSOs did not skyrocket during the periods the company was utilizing its securitization facility, so the increased rate of securitization was not disguising a buildup in receivables from aggressive revenue recognition. However, reporting changes related to cash flow disclosures have significantly impacted the comparability of operating cash flow as discussed in the next section.

Cash Flow Impact of ASU 2016-15, Restatements, and Weakness in Internal Control

Reporting changes related to receivables securitizations have had a dramatic impact on reported operating cash flow over the last year. Historically, the company recorded cash received from receivables that have been securitized as operating cash flows. In the 3/17 quarter, KHC early-adopted ASU 2016-15 governing the classification of certain cash flows. The ASU requires that cash from the collection of payments on sold receivables be recorded as investing cash flows. **However, KHC failed to change its disclosures in the 3/17 quarter which ultimately led to the November 2017 filing of amended 10-Qs for the 6/17 and 3/17 quarters. This also resulted in the company identifying a material weakness in internal control over financial reporting. Consider the note from the amended 10-Q for the 6/17 quarter filed on 11/7/2017:**

> *"In August 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-15 related to the classification of certain cash payments and cash receipts on the statement of cash flows.* ***ASU 2016-15 requires companies to classify cash receipts on sold receivables, or consideration received for beneficial interest obtained for transferring trade receivables in securitization transactions, within investing activities in the statement of cash flows. We early adopted ASU 2016-15 during the***

> ***first quarter of 2017, and this classification should have been made within our statements of cash flows beginning with our Quarterly Report on Form 10-Q for the quarter ended April 1, 2017, including retrospective application. Our financial statements have been restated to correctly classify cash receipts from the payments on sold receivables (which are cash receipts on the underlying trade receivables that have already been securitized) to cash provided by investing activities (from cash provided by operating activities) within our condensed consolidated statements of cash flows.*** *We have restated certain notes to the condensed consolidated financial statements to reflect the impacts of this cash flow correction, including Note 1, Background and Basis of Presentation, Note 11, Financing Arrangements, and Note 16, Supplemental Financial Information.*
>
> *Correspondingly, this Form 10-Q/A amends and restates Item 2 of Part I, which includes our revised discussion of liquidity and capital resources to reflect the impact of the cash flow correction. Item 4 of Part I includes our revised assessment of the effectiveness of our disclosure controls and procedures.* ***This restatement resulted in the identification of a material weakness in internal control over financial reporting related to our adoption and disclosure of new accounting standards. In addition, pursuant to the rules of the Securities and Exchange Commission, Item 6 of Part II of the Original Form 10-Q has been amended to contain currently-dated certifications from our Chief Executive Officer and Chief Financial Officer, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002."***

Moving the cash collected on securitized receivables to investing cash flows resulted in a huge hit to reported operating cash flows. Like several other companies we have seen, not long after the implementation of the ASU, the company put plans in motion to terminate its securitization program. **However, cash flow is being significantly impacted by the unwinding of the securitization program. The company states in the liquidity section of its 6/18 10-Q:**

> *Net Cash Provided by/Used for Operating Activities:*
>
> *Net cash provided by operating activities was $229 million for the six months ended June 30, 2018 compared to net cash used for operating activities of $178 million for the six months ended July 1, 2017. This change was primarily driven by a federal tax refund received in the first quarter of 2018 and decreased cash payments for employee bonuses in 2018.* ***These increases in cash provided by operating activities were partially offset by unfavorable changes in trade receivables, as fewer were non-***

cash exchanged for sold receivables in connection with the wind-down of our U.S. securitization program in the second quarter of 2018.

Net Cash Provided by/Used for Investing Activities:

Net cash provided by investing activities was $579 million for the six months ended June 30, 2018 compared to $423 million for the six months ended July 1, 2017. This increase was primarily due to decreased capital expenditures, which was driven by the wind-up of Integration Program footprint costs, and ***higher cash collections on previously sold receivables in connection with the wind-down of our U.S. securitization program in the second quarter of 2018.*** *These increases in cash provided by investing activities were partially offset by the cash paid to acquire Cerebos on March 9, 2018. We expect 2018 capital expenditures to be approximately $850 million.*

We can see the magnitude of these impacts in the table below which adjusts reported operating cash flow for receivables-related amounts included in the investing section of the cash flow statement:

6 months ended:	6/30/2018	7/1/2017
Cash Flow Impact from Trade Receivables (operating section)	-$2,001	-$1,598
Cash Receipts on Sold Receivables (investing section)	$1,221	$1,069
Net Cash Flow Impact from Receivables	-$780	-$529
Reported Cash from Operations	$229	-$178
CFO Adjusted to Include Receipts on Sold Receivables	$1,450	$891

We see that the wind-down of the securitization program resulted in trade receivables being a much larger drain on cash flows from operations as the company is no longer selling them off. However, this was partially offset by a boost to investing cash flows from the retained interest on previously-securitized receivables being paid off. Note that the company also disclosed the following in its 10-Q filing for the 6/18 quarter regarding the wind-down:

"In June 2018, we issued approximately $3.0 billion aggregate principal amount of long-term debt. ***We used approximately $500 million of the proceeds from the New Notes in connection with the wind-down of our U.S. securitization program in the second quarter of 2018."***

We assume that part of these borrowed funds was used to pay off the retained interests.

In conclusion, after adjusting out all the noise, accounts receivable DSOs have been increasing some, but not to an alarming degree. Also, growth in cash flow from operations after adding back cash collected from previously securitized receivables is stronger than what has been indicated by reported operating cash flows in the last couple of quarters. However, adjusted cash flow growth is still misleading because of the paydown in retained interests. This should all normalize over the next couple of quarters as the company completes the wind-down of its US securitization program.

Accounts Payable Increasing

Like all the packaged food companies we have looked at, KHC's cash flow has benefited from extending payable terms with suppliers. The company began disclosing in its 10-K that it was utilizing structured payment terms to stretch its accounts payable with suppliers:

> *"Additionally, we enter into various structured payable arrangements to facilitate supply from our vendors. Balance sheet classification is based on the nature of the agreements with our various vendors. For certain arrangements, we classify amounts outstanding within other current liabilities on our consolidated balance sheets. We had approximately $188 million on our consolidated balance sheets at December 30, 2017 related to these arrangements. There were no amounts related to these arrangements on our consolidated balance sheets at December 31, 2016."*

The 12/17 10-K is the first place we have seen this disclosure and given that there were no amounts listed for 2016, we believe the structured payable arrangements were not material until towards the end of 2017.

Also, we take the above disclosure to mean that all of the quantified structured payable amounts are included in other current liabilities, so we will add those amounts to accounts payable when calculating days payable (DSP) which are shown in the following table:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Accounts payable	$4,326	$4,241	$4,449	$3,947
Structured Payables in Accrued Liabilities	$88	$141	$188	$0
Adjusted Payables	$4,414	$4,382	$4,637	$3,947
Cost of Sales	$4,321	$4,059	$4,200	$4,000
Days Payable	93.2	98.5	100.7	90.0

	7/01/2017	4/01/2017	12/31/2016	10/02/2016
Accounts payable	$3,888	$3,936	$3,996	$3,456
Structured Payables in Accrued Liabilities	$0	$0	$0	$0
Adjusted Payables	$3,888	$3,936	$3,996	$3,456
Cost of Sales	$4,204	$4,125	$4,398	$4,049
Days Payable	84.4	87.1	82.9	77.9

	7/03/2016	4/03/2016	1/03/2016	9/27/2015
Accounts payable	$2,960	$2,773	$2,844	$2,719
Structured Payables in Accrued Liabilities	$0	$0	$0	$0
Adjusted Payables	$2,960	$2,773	$2,844	$2,719
Cost of Sales	$4,262	$4,192	$4,720	$4,492
Days Payable	63.4	60.4	55.0	55.2

The increase in payables is still boosting days payable, but the year-over-year pace of expansion is slowing. Consider the company's commentary on full-year 2017 operating cash flow from its 2017 10-K filing:

> *"**The decrease in cash provided by operating activities** was primarily driven by the $1.2 billion pre-funding of our postretirement benefit plans in 2017, lower collections on receivables as more were non-cash exchanged for sold receivables, **favorable changes in accounts payable from vendor payment term renegotiations that were less pronounced than the prior year,** and increased cash payments of employee bonuses in 2017."*

Clearly, the company is running out of room to stretch its payables and we can't help but wonder if the appearance of the structured payable disclosure is an indication that the company was "pulling out all the stops" to delay payments. We would also be interested to know the details on what is different about the terms of the structured payable amounts that cause them to be disclosed as other current liabilities rather than traditional payables.

Just a "back of the envelope" calculation shows that if payables had risen in-line with cost of sales from the year-ago period that payables would have been about $400 million lower than what was reported. This amounts to the bulk of the growth in cash from operations for

the 6-month period ended 6/18 even after including cash collected on securitized receivables in operating cash flow. So, while the benefit of extending terms is waning, it is still a very significant boost to cash flow growth.

Dividend Cash Flow Coverage Looks Tight

The following table shows the trailing 12-month free cash flow and the cash dividend paid for the 6/18 and 6/17 periods adjusted to include cash collected on securitized receivables as operating cash flows:

Trailing-12 months ended:	6/30/2018	7/1/2017
Reported Cash from Operations	$934	$1,572
Cash Receipts on Sold Receivables	$2,438	$2,453
Adjusted Cash from Operations	$3,372	$4,025
Capex	$965	$1,423
Free Cash Flow	$2,407	$2,602
Dividend	$3,113	$3,684

Consider the statement from management in the 12/17 quarter conference call regarding the outlook for 2018.

> *"Below the line, we are still targeting adjusted EPS growth and strong cash generation in 2018. This should be aided by tax favorability, where we now expect an effective tax rate of approximately 21% for the full year in 2018. I will also note that based on successful recent refinancing activity, we now expect incremental interest expense in 2018 of roughly $80 million versus the $100 million we previously outlined.* ***And in terms of cash generation, we continue to expect a significant step-up in 2018 despite a near-term headwind to working capital from recent termination of our accounts receivable securitization and factoring program in the U.S."***

KHC made approximately $1.5 billion in one-time pension contributions during the 12/17 quarter. Just that drain dropping out of trailing 12-month operating cash flow in the 12/18 quarter will cause a significant step-up in reported growth in operating cash flow for full-year 2018. However, if we add the pension contribution back to the 6/18 trailing 12-month operating cash flow number, it brings adjusted free cash flow to about $3.9 billion which still leaves the dividend consuming about 80% of free cash flow. We also noted in the

previous section that the rise in accounts payable has been a huge boost to operating cash flow, but the pace of the increase is narrowing quickly. Capex is declining due to the wind-down of the restructuring and integration program and is expected to fall to about $850 million for the full year ended 2018. However, most of the decline is already reflected in the trailing 12-month numbers. Therefore, even when the unusual factors are behind the company, the dividend will still consume the bulk of free cash and with net debt-to-EBITDA approaching 4x, future dividend growth seems very limited.

Trade Receivable Allowances Declining

The following table shows the allowance for doubtful accounts which the company shows specifically as a reduction of trade receivables on the balance sheet. (It does not appear to be tied at all to retained interest in sold receivables left on the balance sheet.)

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Trade Receivables	$1,950	$1,044	$921	$938
Allowance- Applied to Trade Receivables	$24	$24	$23	$29
Gross Receivables	$1,974	$1,068	$944	$967
Allowance % of Gross Receivables	1.2%	2.2%	2.4%	3.0%

	7/1/2017	4/1/2017	12/31/2016	10/02/2016
Trade Receivables	$913	$886	$769	$855
Allowance- Applied to Trade Receivables	$28	$30	$20	$28
Gross Receivables	$941	$916	$789	$883
Allowance % of Gross Receivables	3.0%	3.3%	2.5%	3.2%

As we discussed in a section above, trade receivables balances ballooned in the 6/18 quarter as the company unwound its receivables securitization program in that period. However, despite the near-90% sequential increase in trade receivables in the quarter, the allowance for bad debts remained flat and the was actually down from the year-ago period. KHC does not disclose the provision expense, but we calculate it would have taken almost $20 million (1.2 cents per share) in incremental provision expense to keep the allowance as a percentage of gross trade receivables flat with the 3/18 quarter.

Restructuring Program and Impairment Charges

KHC is winding down an integration program related to the Heinz deal that was begun in 2015. Through 6/18 the company incurred over $2.1 billion including $542 million of

severance costs, $883 million of non-cash asset costs, $601 million in implementation costs and $109 million of other exit costs. Despite the program being deemed "substantially complete" as of 12/17, there were $80 million in charges taken in the first six months of 2018 with $22 million of that falling in the second quarter. In addition to the integration program, the company has several smaller restructuring programs which are expected to result in the elimination of 1,400 positions. These programs resulted in charges of $135 million in the fourth quarter. All of the $157 million in second quarter charges were added back to adjusted EPS figures. Integration charges for a deal the size of the Heinz integration are understandable. The concern will be if more restructuring plans are announced in the future as ongoing charges cloud the quality of adjusted earnings as operating expenses could be getting lumped in with the "one-time" charges.

We also note that the company recorded $164 million in goodwill impairments in the quarter related to declining margins in its Australia and New Zealand reporting unit. In addition, the company disclosed that of its 20 reporting units, 4 has fair values that were less than 10% above carrying value. This could be an indication of future impairment charges should conditions worsen in those units. KHC also recorded $101 million in impairment charges related to indefinite-lived intangibles related to sales and margins declines for its *Quero* brand in Brazil and also identified its *ABC* and *Smart Ones* brands as having fair values that are less than 10% above carrying value.

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	Description
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.

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