SIENAcollege

BJORKLUND FUND

March 23, 2018

GameStop: (GME)

David Blanco

Sector: Consumer Discretionary
Industry: Computer and Electronic Retail
Current Price: $14.01
Target Price: $15.26

Gamestop is a videogame retailer specialized in videogame hardware and software. It has expanded to sell consumer electronics. It currently is expanding its technology brands segment, consisting of Spring Mobile and Simply Mac.

SELL

Current Price:	$14.01
Target Price:	$15.26
Market Cap:	1.42B
Beta:	1.0

Other key Metrics/Ratios

Thesis: A statement culminated from an analysis of catalysts, financial review, pro-forma indications, and other aspects of your decision as to why the stock is over/under/fairly priced. Your argument.

Catalysts:

- Short Term (within the year): Decreasing physical sales of video games and related products.
- Mid-term (1 year): Movement towards digital video game sales

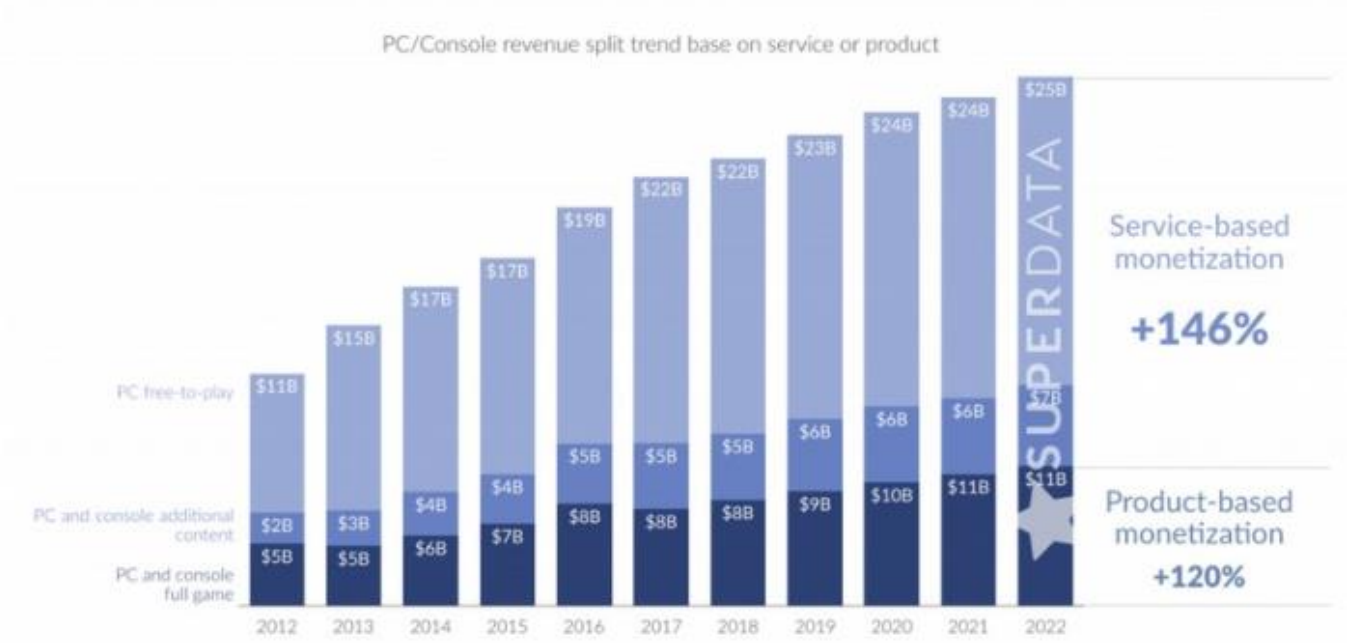
Industry Trends:

GameStop has seen its price plummet since November 2015, when its Q3 results dramatically underperformed estimates. Since then, GameStop's price has moved opposite to the S&P 500 Computer and Electronics Index. The videogame entertainment industry has been blooming for the past three years, yet GameStop is not only not profiting from these industry changes but is continuing to drop. Before 2015, GameStop was closely related to the Electronics Index since a large portion of videogame sales was done through physical distributors, of which GameStop was the undisputed leader in America. However,

technological innovation has led to a popularization of digital sales over physical sales. By 2021, digital sales are to account for nearly 93% of all game sales.[1]

Since GameStop's model revolves around physical sales, it seems evident why investors have viewed GameStop negatively. This does not mean that GameStop has not attempted to diversify. It has pushed for digital sales using gift cards of all kinds and sales of games through codes. It has managed to partner with developers to push promotions such as downloadable content for videogames if they buy through the store, yet its revenue continues to decrease; it is evident that the convenience of digital sales is ever growing, with online payment methods such as PayPal and credit card information becoming easier and more streamlined.

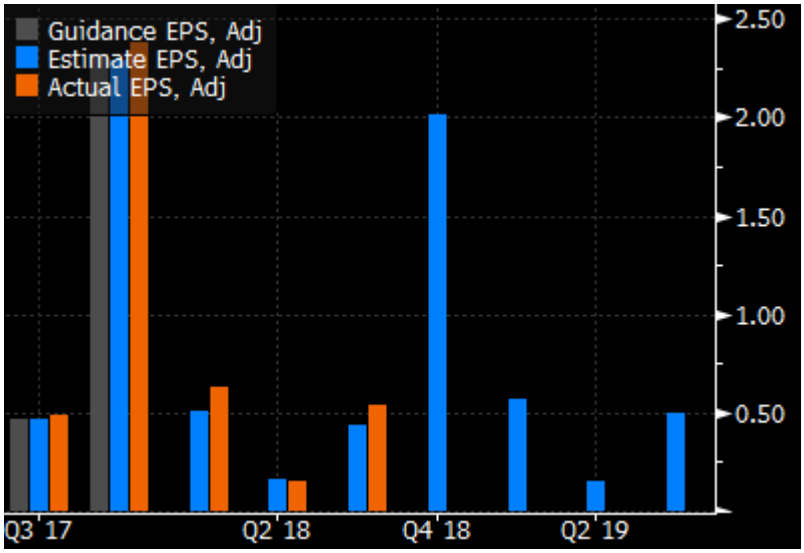
Another industry trend that has increased revenues for the electronics entertainment industry but cannot be translated into the business model of GameStop is the growth of micro transactions and DLC.



Micro transactions and DLC along with other services are becoming the predominant source of revenue for videogame sales, having tripled since 2012.[2] The previous model of full-priced $60 games has slowly been decreasing and the free-to-play (with fees included) has continued to grow. Other increasingly popular model like subscription based models have also become popular with triple AAA developers, yet they naturally remove the middleman from the long-term transaction, that being GameStop. As it stands, industry trends seem to overwhelmingly hurt GameStop. Other factors, such as increasing download speed have made digital sales not only easier, but also more convenient than physical purchases. GameStop's central business model is becoming obsolete by the year, and their decreasing revenue reflect that fact.

[1] http://business.financialpost.com/technology/gaming/digital-sales-to-account-for-nearly-93-of-all-game-sales-by-2021-report

[2] https://www.gameprime.org/2017/12/pc-console-dlc-revenue-tripled-2012/



Since 2015, analysts have taken these factors into account. The estimate vs actual adjusted EPS shows two crucial facts about GameStop. The first is that GameStop has been able to marginally beat the predictions due to slightly higher revenue than expected. However, the issue remains that estimate EPS continues to drop, as does the price of the stock. Revenue continues to drop as industry trends make GameStop irrelevant, as GameStop cannot jump into digital sales. Its last attempt in this market was the push for digital sales through gift cards and redeemable codes. However, nowadays it is just as easy to simply purchase the game directly online, making going to GameStop an unnecessary hassle.

AT&T:

GameStop has attempted to maintain revenue growth by diversifying into mobility stores. In 2013, it acquired Spring Mobile, an authorized AT&T retailer, and have since then expanded from the original 90 stores to 1,403 in 2017. These decisions have had limited, yet successful results.

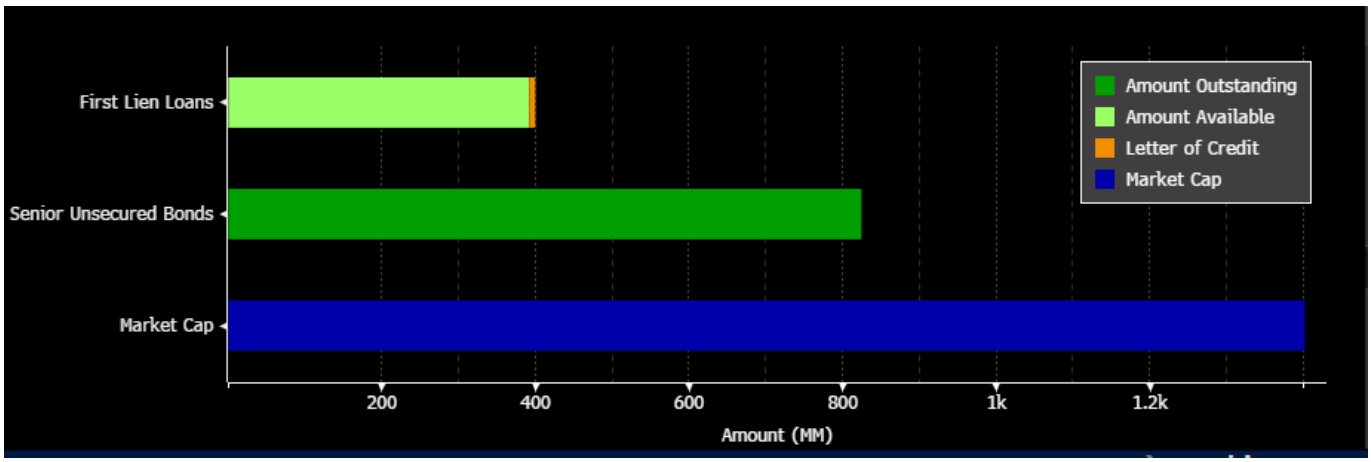
In Millions of USD except Per Share	2016 Y	2017 Y	Last 12M	2018 Y Est	2019 Y Est
12 Months Ending	01/30/2016	01/28/2017	10/28/2017	01/31/2018	01/31/2019
Revenue	9,363.8	8,607.9	8,767.5	8,960.2	8,838.9
+ Sales & Services Revenue	9,363.8	8,607.9	8,767.5		
- Cost of Revenue	6,445.5	5,598.6	5,744.0		
+ Cost of Goods & Services	6,445.5	5,598.6	5,744.0		
Gross Profit	2,918.3	3,009.3	3,023.5	3,051.7	3,030.0
+ Other Operating Income	0.0	0.0	0.0		
- Operating Expenses	2,247.1	2,400.4	2,471.9		
+ Selling, General & Admin	2,108.9	2,252.6	2,317.3		
+ Research & Development	0.0	0.0			
+ Depreciation & Amortization	156.6	165.2	153.5		
+ Other Operating Expense	-18.4	-17.4	1.1		
Operating Income (Loss)	671.2	608.9	551.6	549.4	532.4
- Non-Operating (Income) Loss	23.0	53.0	56.0		
+ Interest Expense, Net	23.0	53.0	56.0		

	Fiscal Year 2016		Fiscal Year 2015		Fiscal Year 2014	
	Net Sales	Percent of Total	Net Sales	Percent of Net Sales	Net Sales	Percent of Net Sales
New video game hardware[1]	$ 1,396.7	16.2%	$ 1,944.7	20.8%	$ 2,028.7	21.8%
New video game software	2,493.4	29.0	2,905.1	31.0	3,089.0	33.2
Pre-owned and value video game products	2,254.1	26.2	2,374.7	25.4	2,389.3	25.7
Video game accessories	676.7	7.9	703.0	7.5	653.6	7.1
Digital	181.0	2.1	188.3	2.0	216.3	2.3
Technology Brands[2]	814.0	9.5	534.0	5.7	328.6	3.5
Collectibles	494.1	5.7	309.7	3.3	75.8	0.8
Other[3]	297.9	3.4	404.3	4.3	514.7	5.6
Total	$ 8,607.9	100.0%	$ 9,363.8	100.0%	$ 9,296.0	100.0%

Revenue is expected to increase marginally, moved primarily by these new businesses. These charts indicate that GameStop's market segments other than collectibles and technology brands (Spring Mobile) are decreasing. Revenue is expected to increase while gross profit expected to remain relatively similar due to higher COGS. However, EPS is expected to fall as GameStop themselves recognize the technology brand segment requires higher S&A costs, decreasing the EBITDA margin. GameStop indicated that it aims to have less than 50% of its revenue come from videogame sales, meaning they are trying to reduce their main business due to how much it is shrinking. However, it is clear that the company is in a dire situation, with its best-case scenario being becoming AT&T's retail seller, with a reduced EBITDA margin and lower EPS. This not only has negative cash implications, but it restricts the company's ability to grow. GameStop itself indicated how its stores are restricted to sell exclusively AT&T related products by contract, and thus it is unable to profit from selling its competitors' products. Therefore, its best-case scenario is essentially becoming AT&T's retail subsidiary.

Debt:

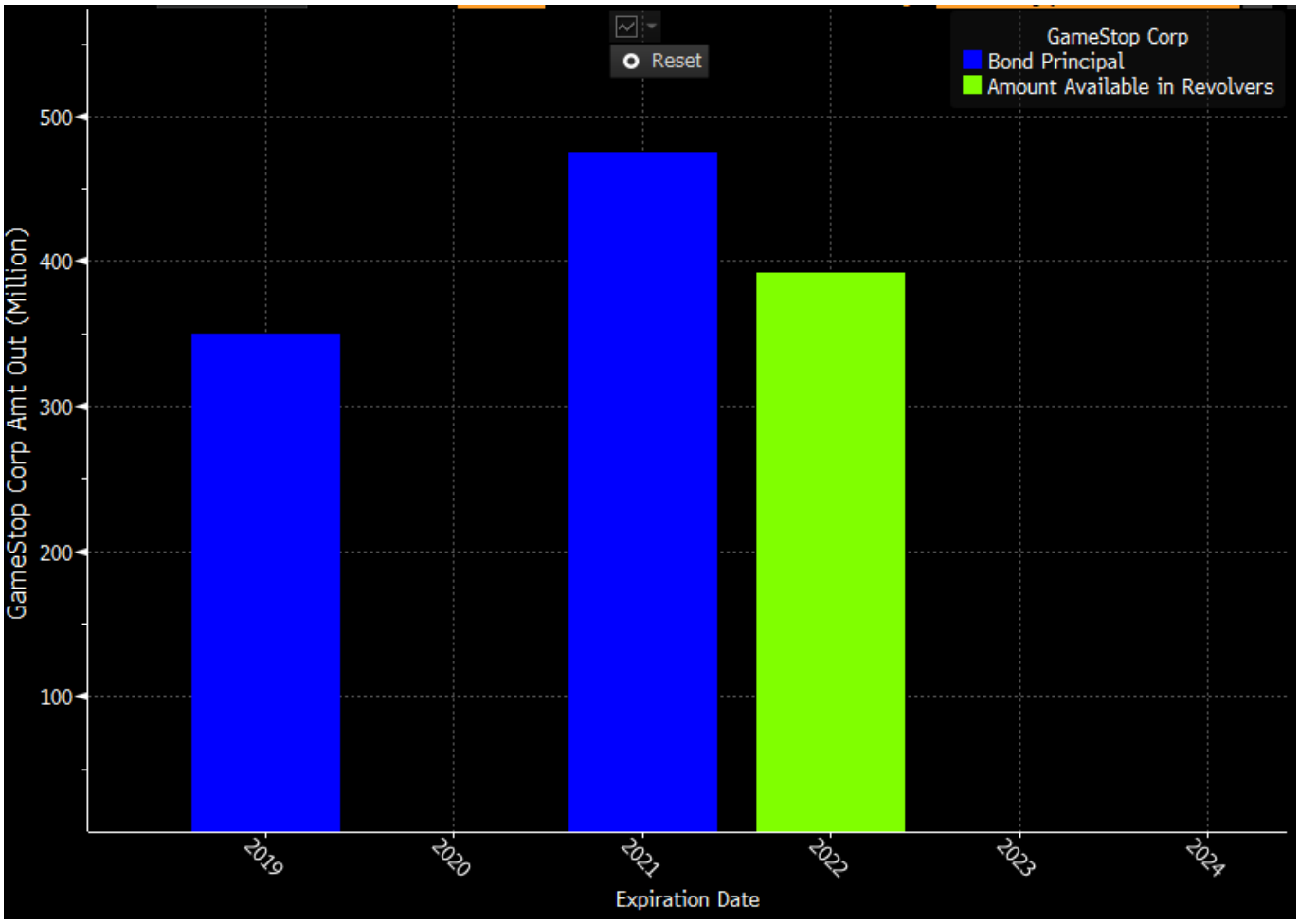
This best-case scenario, however, may not be as feasible as it appears.



A large portion of GameStop's operations is financed through long-term debt. In 2017, GameStop was forced to reissue its senior unsecured debt of $475M after payment and had to issue an additional $400M. Given how their latest annual fiscal year produced only $537M in net cash proceeds, GameStop would need to radically increase its operating cash inflows by 2021 to payback its debt.

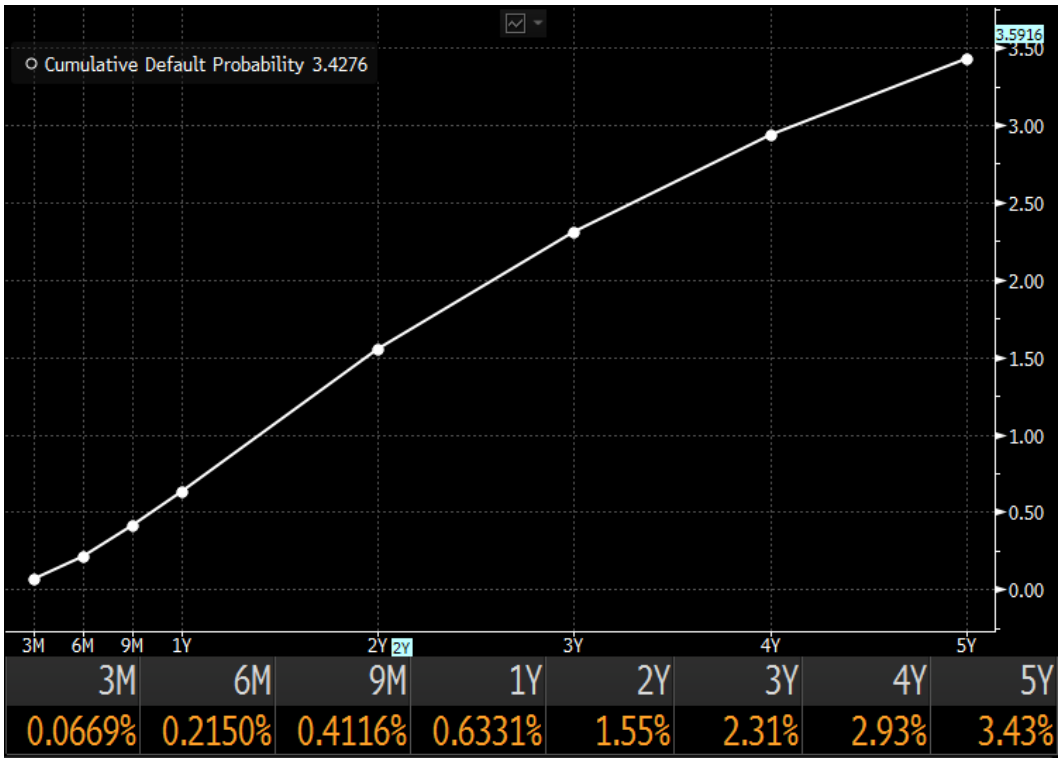
In Millions of USD except Per Share	2014 Y	2015 Y	2016 Y	2017 Y	Last 12M
12 Months Ending	02/01/2014	01/31/2015	01/30/2016	01/28/2017	10/28/2017
Cash from Operating Activities					
+ Net Income	354.2	393.1	402.8	353.2	349.3
+ Depreciation & Amortization	169.2	156.5	158.2	166.7	154.9
+ Non-Cash Items	54.7	24.6	21.8	42.8	32.7
+ Stock-Based Compensation	7.0	15.8	25.5	18.6	17.0
+ Deferred Income Taxes	-2.7	9.2	-1.5	-37.2	
+ Other Non-Cash Adj	50.4	-0.4	-2.2	61.4	29.9
+ Chg in Non-Cash Work Cap	184.6	-93.7	74.0	-25.6	-148.5
+ (Inc) Dec in Accts Receiv	-1.4	-44.3	-58.1	-43.9	-19.9
+ (Inc) Dec in Inventories	-86.9	-24.8	-49.2	14.7	-217.8
+ Inc (Dec) in Other	272.9	-24.6	181.3	3.6	89.2
+ Net Cash From Disc Ops	0.0	0.0	0.0	0.0	0.0
Cash from Operating Activities	762.7	480.5	656.8	537.1	388.4

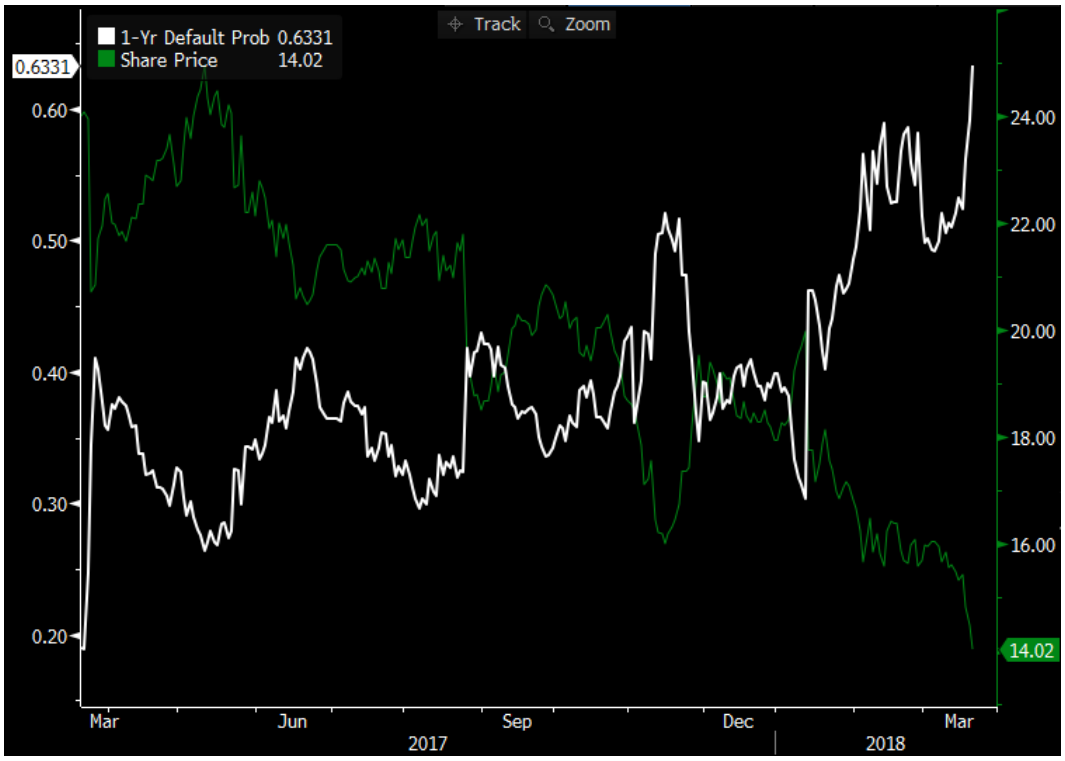
However, operating cash inflows are not expected to increase. Currently the LTM indicate over $200M lower cash inflows, which are mostly attributed to Q4's usual high performance due to holiday sales, but even by normalizing said decrease in inventory, operating cash inflows are not expected to change significantly. While they are expanding into its technology brand, it is mostly to offset the decrease in revenue in its other segments. However, as stated before, this new segment is expected to be less profitable.



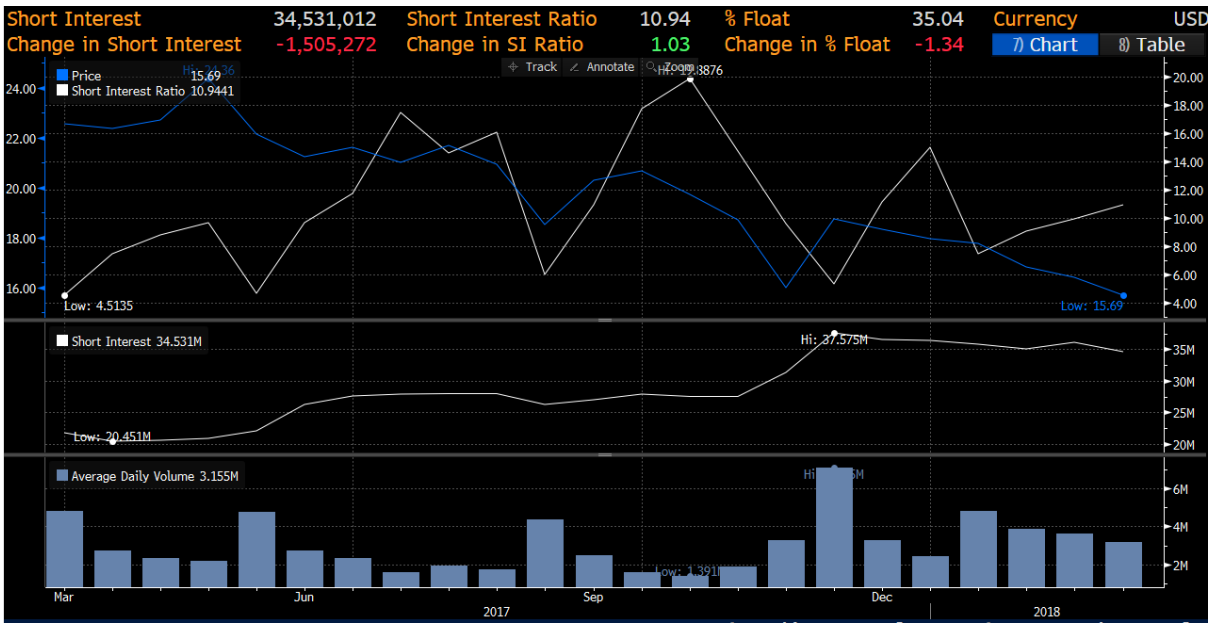
By 2021, GameStop's revolving credit facility won't be able to refinance GameStop's debt, and given how GameStop's bond yield continue to increase, it is becoming increasingly probable that GameStop will become unable to rely on debt, perhaps even repay it. Currently, GameStop holds a Ba1 rating on its senior unsecured

looks, but S&P has already indicated a negative outlook for the company. With its increased debt and lack of growth indicators, it is no surprise GameStop's probability of default is increasing.





Its share price continues to drop as fear of default continue to increase. While the price has decreased in the past three years due to its reduced income due to its business model, I argue that its price will continue to drop as its long-term financial stability will become weaker by the year is nothing changes.



GameStop's short interest continues to increase, even after its price's significant decrease in the past quarter.

Ownership Type	03/12/17	Curr	Change
11) Investment Advisor	75.80	84.47	+8.67
12) Hedge Fund Manager	12.07	6.89	-5.18
13) Pension Fund	3.39	2.19	-1.20
14) Bank	2.83	2.00	-0.83
15) Individual	2.27	1.72	-0.55
16) Sovereign Wealth Fund	0.93	0.97	+0.04
17) Insurance Company	0.97	0.78	-0.19
18) Private Equity	0.28	0.44	+0.16
19) Brokerage	0.45	0.28	-0.17
20) Government	0.82	0.13	-0.69
21) Endowment	0.06	0.04	-0.02

Added to this, hedge fund managers have pulled out significantly from the company, indicating a negative outlook in the short term for the company. Therefore, the company is expected to perform poorly in the short-term, its long-term solution is essentially changing to a new subindustry will lower EBITDA margins and restricted growth to only AT&T products, and the company might not even have the long-term financial strength to invest into the lower-performing business. As it stands, GameStop will continue to deteriorate if nothing changes.

Management:

On the human side, GameStop does not seem to perform well. Its longtime CEO Paul Raines stepped down in November and was declared deceased in March due to his battle with cancer.[3] Mr. Raines had an excellent reputation within the company, and while his death was detrimental for the company, it was an opportunity for GameStop to reshape how they work. However, GameStop has been struggling to indicate any positive changes, with both its COO and executive vice president both fired without any reason provided by the company.[4]

The new CEO, Michael Mauler, has not addressed GameStop's turnover issues and reputation of its company strategy "Circle of Life". It relies on customers buying games, selling them back, and use in-store credit to buy more games.[5] The main issue is that customers are dreadfully aware how profitable this business is, and instead of trying to find a way to reshape or even rebrand the strategy has left to both customers and staff dissatisfied. GameStop has the infamous reputation of being one of the worst companies to work, with employees believing the company's aggressive stance on the "Circle of Life" angers customers and punishes staff for being unable to reach the impossible goals.[6] Anonymous employees and storeowners are being vocal about how this is a management issue that has been unaddressed and continues to hurt the company.[7] Given how management continues to shuffle and the new CEO refuses to acknowledge that its most profitable model is the biggest detriment to customer relations and employee satisfaction, it seems GameStop management cannot be trusted to pull a Hail Mary and successfully pull out the company from its dire situation, with a serious possibility of default in the not-so-distant future.

Default:

Given the industry GameStop operates, a default would not be as terrible for shareholders. It has significant investment in land and property, and its inventory is highly liquid. However, given its significant goodwill and other intangible assets, not everything is salvageable. By knocking out these items and valuing its real estate value at roughly $2.1B (as well as adjusting other asset items by their liquidity), after all debt is paid for, GameStop would still have a net $546M in cash. Currently, there are 101.3M shares outstanding, indicating the liquidation return per share would be $5.40. This price serves as the lower limit for this proposal, as reaching a price per share lower than this would be impossible even if GameStop declared bankruptcy. Given how the price continues to drop, if nothing changes, this means a short on GameStop could potentially be as high as 61%.

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[3] https://www.dallasnews.com/business/retail/2018/03/05/former-gamestop-ceo-paul-raines-dies-after-a-battle-with-cancer
[4] https://www.wsj.com/articles/gamestop-fires-two-executives-days-after-naming-new-ceo-1518188472
[5] https://kotaku.com/we-are-all-scared-for-our-jobs-gamestop-employees-talk-1791963185
[6] https://kotaku.com/5934095/report-gamestop-is-one-of-the-worst-places-to-work-in-america
[7] https://www.forbes.com/sites/erikkain/2017/02/02/rumors-of-gamestops-terrible-circle-of-life-program-may-be-overblown/#6539ac7d3683

Conclusion:

GameStop is a perfect indication of how technological innovation can make a middleman obsolete. GameStop has been unable to exploit any other means of business and is currently trying to exit the market. However, its debt obligations and decreasing operating cash inflows may make their entry into AT&T retailing impossible. Even if they somehow make it, the firm will by them have shrunk significantly by exiting its main business and is impeded from growth as its long-term contract with AT&T forces them to sell its products exclusively. If they somehow manage to exit exclusivity clause without ending relations, GameStop will be in a business with lower EBITDA margin in which it holds a small market share. As a whole, GameStop short-term outlook is stable, but any improvement are unlikely looking at GameStop's management. In the worst-case scenario, GameStop could seriously be looking at bankruptcy, with potential return for a short being as high as 61%.

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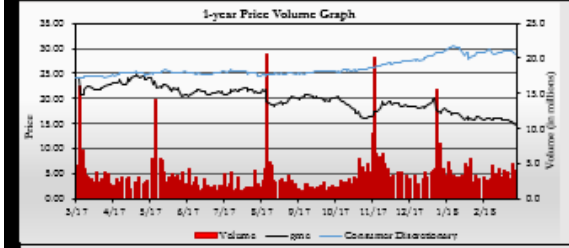
Output:

GameStop Corp. (gme)

CENTER FOR GLOBAL FINANCIAL STUDIES

NEUTRAL

Analysis by Blanco	Current Price:	$14.02	Intrinsic Value	$85.79	Target 1 year Return: 19.37%
3/23/2018	Divident Yield:	10.5%	Target Price	$15.26	Probability of Price Increase: 100



Description

GameStop Corp. operates as an omnichannel video game retailer.

General Information

Sector	Consumer Discretionary
Industry	Specialty Retail
Last Guidance	February 12, 2018
Next earnings date	March 28, 2018

Market Assumptions

Estimated Equity Risk Premium	5.10%
Effective Tax rate	21%

Market Data

Market Capitalization	$1,420.29
Daily volume (mil)	4.39
Shares outstanding (mil)	101.30
Diluted shares outstanding (mil)	101.78
% shares held by institutions	109%
% shares held by investment Managers	93%
% shares held by hedge funds	13%
% shares held by insiders	2.73%
Short interest	34.09%
Days to cover short interest	9.55
52 week high	$25.31
52-week low	$14.35
Volatility	38.57%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
10/29/2016	-1.87%	9.07%
1/28/2017	0.26%	-9.86%
4/29/2017	4.81%	-0.65%
7/29/2017	3.41%	1.68%
10/28/2017	0.99%	6.46%
Mean	1.52%	1.34%
Standard error	1.0%	5.1%

Market and Credit Scores

Recommendation (STARS) Value	-4
Recommendation (STARS) Description	Buy
Quality Ranking Value	B
Quality Ranking Description	Below Average
Short Score	-5
Market Signal Probability of Default % (Non-Rating)	-5.753%
Credit Model Score (Non-Rating)	bbb-

Industry and Segment Information

LTM Revenues by Geographic Segme	LTM Revenues by Business Segments
#VALUE!	United States--64%
#VALUE!	Canada--4%
#VALUE!	Australia--7%
#VALUE!	Europe--15%
#VALUE!	Technology Brands--9%

Peers

Activision Blizzard, Inc.	Staples, Inc.
Electronic Arts Inc.	Bic Camera Inc.
Best Buy Co., Inc.	Zynga Inc.
AutoZone, Inc.	JB Hi-Fi Limited
Fnac Darty SA	Microsoft Corporation

Management	Position	Total Compensation Growth	Stock Price Growth During Tenure
DeMatteo, Daniel	Co-Founder & Executive Chairman	-100% per annum over 4y	9.22% per annum over 4y
Rainey, J.	Former CEO & Director	-100% per annum over 4y	9.22% per annum over 4y
Lloyd, Robert	Chief Financial Officer and Executive Vice Pres	-100% per annum over 4y	9.22% per annum over 4y
Maulor, Michael	CEO & Director	-100% per annum over 2y	-12.15% per annum over 2y
Crawford, Troy	Chief Accounting Officer and Senior Vice Presi		
Kaufman, Daniel	Executive VP, Chief Legal & Administrative Off		

Profitability	gme (LTM)	gme Historical	Peers' Median (LTM)
Return on Capital (GAAP)	10.2%	12.60%	15.20%
Operating Margin	6%	5.97%	12.63%
Revenue/Capital (GAAP)	1.77	2.11	1.20
ROE (GAAP)	20.7%	22.2%	-1.1%
Net margin	5.2%	5.1%	6.0%
Revenue/Book Value (GAAP)	3.97	4.32	-0.18
Invested Funds	**gme (LTM)**	**gme Historical**	**Peers' Median (LTM)**
Cash/Capital	15.3%	12.7%	27.7%
NWC/Capital	-3.3%	-6.4%	-6.7%
Operating Assets/Capital	51.8%	54.7%	52.3%
Goodwill/Capital	36.2%	39.0%	26.8%
Capital Structure	**gme (LTM)**	**gme Historical**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.53	0.44	0.53
Cost of Debt	7.0%	7.1%	4.0%
CGFS Rating (F-score, Z-score, and default Probability	BB		
WACC	12.1%	11.6%	8.4%

Porter's 5 forces (Scores are percentiles)

Valuation

Forecast Assumptions	Explicit Period (6 years)	Continuing Period
Revenue Growth CAGR	2%	2%
Average Operating Margin	6%	7%
Average Net Margin	3%	4%
Growth in Capital CAGR	4%	2%
Growth in Claims CAGR	0%	2%
Average Return on Capital	9%	8%
Average Return on Equity	9%	7%
Average Cost of Capital	13%	14%
Average Cost of Equity Ke	17%	17%