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GameStop (GME): 3Q10 Results and 2011 Outlook

Summary:

GameStop Corporation performed quite well during the third quarter given the overall sluggish industry and macro environments. We are satisfied with the company's increases in revenues, margins, and earnings. GameStop has gained market share in each of the past two quarters, and we believe that its position as a destination on the day of big game releases allows it to capture a disproportionate share of first-week game sales. With sell-through of games increasingly compressed (the average pre-order volume for big games this year is up 40% over last year, but overall software sales are down), GameStop has a clear competitive advantage over other retailers, so long as its customer base consists primarily of people who must have the game on the first day. Given that clear competitive advantage, we believe investors should pay attention to the success of GameStop's customer loyalty initiatives. GameStop keeps its core customers coming back with rewards, credit for trade-ins, and digital download kiosks, and we think that the company's recent performance reflects this advantage.

In our opinion, market sentiment on GME is overly negative. The bear thesis is based on a belief that the slowdown in industry sales over the last two years is evidence of a secular decline, caused largely by the migration to online game play and digital downloads. We disagree with this view, and think that the softness is in large part due to the decline of the music genre, the Wii, and the increase in the number of free online multiplayer consumers. We also believe that the first two of these drivers were areas that were already under-represented at GameStop. Since the company did not have a huge market share of music or Wii games, it makes sense that it has gained market share the past two quarters. As we expect the downtrend in Wii software and music games to continue, GME should be less impacted than its big box competitors. We expect a return to industry growth in 2Q11 and should the company continue to gain share as the industry bottoms out, we believe it is well positioned for meaningful growth in 2011.

Investment Recommendation: BUY GME with PT of $30.00

Third Quarter (Oct.) Results

GME reported same store sales (SSS)/revenue/operating EPS of +1.1%/$1.9B/$0.38 vs. consensus of +3.5%/$1.95B/$0.37. Management guidance was +3% to +6% SSS and $0.35 to $0.38 in EPS. Although overall comps were light, domestic SSS were strong at +5.3%. The company attributed the weaker than expected overall comps to weak international hardware sales (low margin).

Sales for new video game software grew (+9.1%, vs. -3.2% for the industry according to NPD) due to market share gains on a solid new release slate, used video game products (+4.0%), and other (+8.4%), while new video game hardware sales were down (-14% vs. -18% for the industry according to NPD) due to international weakness. The company gained market share in both new video game software and new video game hardware.

Gross margin increased slightly due to a product mix shift to higher-margin software. Gross margins for used video game products (up to 47.4% from 47.3%) and other (up to 35.9% from 34.9%) both increased, more than offsetting declines for new video game hardware (down to 7.9% from 8.3%) and new video game software (down to 21.7% from 22.6%). Additional data points are listed below:

- Confirmed FY10 guidance for SSS comps of flat to +2.0%, but raised EPS guidance to $2.63 – 2.69 from $2.58 – 2.68.
- The company initiated Q4 guidance for SSS comps of +2.0% to +4.0%, and EPS of $1.53 – 1.59 (vs. prior Q4 implied EPS guidance of $1.46 – 1.59).
- Opening of 57 net new stores (opened 78 and closed 21 stores), bringing total store count to 6,606.
- FY11 guidance for 300 to 400 new store openings, offset by 100 to 200 store closings.
- In September, GameStop announced a $500M repurchase program ($300M for shares and $200M for debt). In Q3 they bought back $200M in debt and $49M in stock (2.61M shares at $18.91/share).

We are encouraged by the 3Q results. Free cash flow and a healthy cash balance have allowed for stock and debt repurchases, which have boosted EPS. Negatives from the quarter included overall revenues lower than Street expectations (new hardware and used software both slightly below plan) and weakness in various international markets where economic recoveries have been slow.

- ***<u>Strong Balance Sheet</u>***

The balance sheet remains strong, in our view. Cash and equivalents were $181M, down from the year-ago period of $292M. Total inventory was up in anticipation of big product releases in early November, namely Activision Blizzard's *Call of Duty: Black Ops* videogame and Microsoft's *Kinect* hardware device. In addition, higher inventory reflected management's planned buildup of used games prior to the holiday quarter. Long-term debt was $248M, just 8% of total capitalization and below the year-ago debt figure of $447M. During the quarter, the company retired $200M of senior notes. Stockholders' equity was $2.7B.

Outlook for Fourth Quarter and 2011

- ***<u>Well Positioned for a Strong 4Q</u>***

We believe GameStop is well-positioned for a strong Q4. As in Q3, we expect the company to again gain market share from a number of high-profile releases that appeal to its core audience, such as *Call of Duty: Black Ops*, *Epic Mickey*, *Need for Speed: Hot Pursuit*, *Assassin's Creed Brotherhood*, *Gran Turismo 5*, and *World of Warcraft Cataclysm*. If the pattern from Q2 and Q3 continues to hold, it is likely that GME captured a disproportionately high share of first week sales for Kinect and *Black Ops*, and is in a position to do so again for other games. We believe the company is on track to record solid sales of the holiday season's big three items (Sony's Move, Microsoft's Kinect, and Activision's *Call of Duty: Black Ops*). We expect Microsoft to sell 5 million Kinect units by the end of GameStop's January quarter, and Sony to sell 3 million Move units.

- ***PowerUp Rewards Program Retains Customer Brand Loyalty***

The customer loyalty program called PowerUp Rewards has been implemented in all U.S. stores and has been quite popular with customers eager for program benefits and gaming/sale information. The program gives GameStop valuable information on its customer base and members have been making purchases three times more often than non-members. PowerUp Rewards could have a positive impact on holiday sales, although we think that the greater impact will be throughout the year, as the program targets customers who buy for themselves, rather than the occasional gift giver. One positive effect of the program will be its emphasis on rewarding purchases of new items, unlike its predecessor, the Edge card, which focused on used merchandise. The focus on new products should drive stickiness among hardcore gamers, who are less likely to switch to competitors due to lower prices or promotions. Although the PowerUp gamer might be forced to pay a higher price in the short-term, there is a tangible long-term incentive for staying loyal to the company. We don't think that PowerUp rewards has much potential to attract more casual customers, as we believe that people who are unfamiliar with gaming are more likely to frequent a large big box retailer with less specialized staff, as they will be there filling other holiday shopping needs.

- ***Digital Initiatives Gaining Traction***

A national roll-out of in-store sale of digital content has also been implemented at all U.S. locations. Customers seem willing and comfortable shopping for content while in a store and having that content available to them when they go home. Other digital initiatives that seem to be working well include e-commerce at the re-tooled website, www.gamestop.com, and increased traffic at the company's recently acquired online gaming platform www.kongregate.com.

- ***Growth Drivers for 2011 and Beyond***

We believe GME can grow EPS at a CAGR of 8-10% over the next few years. This potential growth can be achieved through the following initiatives:

- Continued industry expansion (more gamers)
- Boost in store traffic and overall volume due to lower console prices
- Additional store openings (domestic and international)
- Modest same-store sales growth
- Market share gains due to effective 'event marketing' for major title launches
- Progress on a digital strategy that augments GME's role as a packaged goods retailer
- New customer loyalty/reward programs
- Gross margin improvement due to shifts in product mix (growth of used game segment)
- Industry consolidation/acquisitions/competitive store closings
- Utilization of free cash flow (debt reduction, share repurchases, etc.)