Entertainment & Leisure
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COMPANY UPDATE / ESTIMATE CHANGE

GameStop Corp.

GME — NYSE — Neutral-4

2Q EPS Declined Slightly More Than Expected

Key Metrics

GME - NYSE (as of 8/25/17)		$19.40
Price Target		N/A
52-Week Range		$18.72 - $30.51
Shares Outstanding (mil)		101.4
Market Cap. ($mil)		$1,967
3-Mo. Average Daily Volume		2,530,000
Institutional Ownership		99%
Total Debt/Total Capital (7/17)		26%
ROE (TTM ended 7/17)		15%
Book Value/Share (7/17)		$22.80
Price/Book Value		0.9x
Annual Dividend Rate & Yield	$1.52	7.8%
EBITDA Margin (TTM ended 7/17)		7.9%

EPS FY 1/31* (excludes nonrecurring items)

	2016	Prior 2017E	Curr. 2017E		Prior 2018E	Curr. 2018E
1Q	$0.66		$0.63	A		
2Q	$0.27		$0.15	A		
3Q	$0.49	$0.40	$0.40			
4Q	$2.38	$1.99	$2.02			
Year	$3.77	$3.19	$3.20		$3.22	$3.30
P/E ~	5.1x		6.1x			5.9x

*Fiscal year ends Saturday closest to January 31 of the following year.
Quarterly EPS figures may not add to annual figure due to rounding and changes in the share count from quarter to quarter.

Revenue ($mm)

	2016	Prior 2017E	Curr. 2017E		Prior 2018E	Curr. 2018E
1Q	$1,971		$2,046	A		
2Q	$1,632		$1,688	A		
3Q	$1,959	$1,909	$1,926			
4Q	$3,045	$3,051	$3,040			
Year	$8,608	$8,595	$8,700		$8,500	$8,625

Company Description: *GameStop Corp. is the world's largest multi-channel videogame retailer. The company sells new and pre-owned software, hardware, and accessories for current gaming systems and the PC. Recent diversification efforts have led to a smartphone/mobile device retail sales & service presence that includes AT&T Wireless/Spring Mobile, Simply Mac, and Cricket stores, collectively referred to as technology brand stores. GME recently operated just over 7,500 total stores in 14 countries. This included 3,902 U.S. videogame stores, 1,998 international videogame stores, 1,508 technology brand stores, and 95 collectible stores.*

Investment Highlights

- **2Q profit declined despite higher sales.** Net sales increased 3.4% from the year ago period to $1.688 billion, better than the street consensus expectation of flat sales. Videogame hardware sales rose due largely to Nintendo's new Switch console. Videogame software continued a negative trend. Non-videogame segments such as Technology Brands (includes the company's AT&T Wireless/Spring Mobile, Simply Mac, and Cricket retail stores) and Collectibles (online and physical stores) continued to grow.
- **The sales gain was negated by higher expenses.** Gross margin declined 90 basis points due to shifts in the sales mix, including lower sales of pre-owned software, which is typically a high margin category. SG&A expenses rose faster than sales, leading to a 37.7% decline in operating income, excluding a one-time gain in the recent quarter. Adjusted EPS, excluding the gain, were $0.15 compared to $0.27 a year ago. The street consensus estimate was $0.16.
- **Earnings guidance for fiscal 2017 was maintained.** This includes projected EPS of $3.10-$3.40. We have fine-tuned our financial outlook, which includes EPS declines for the remaining two quarters of the fiscal year. This reflects a robust slate of videogame releases, but continued pressure on physical videogame sales due to industry trends and costs associated with GME's integration of non-videogame businesses.
- **We maintain our Neutral rating.** Given the low valuation and high dividend yield, we are somewhat attracted to the stock. However, offsetting factors to us include industry trends related to consumers' growing comfort in downloading videogame content (entire games and incremental 'follow-on' content) and some concern over GME's business diversification strategy. We consider the dividend, currently yielding 7.8%, adequately covered by cash flow at this time.

Note Important Disclosures on Pages 7-8.
Note Analyst Certification on Page 7.

Exhibit 1
Consolidated Statements of Income (figures in millions except percentages and per share data)

	13 Weeks Ended			26 Weeks Ended		
	07/29/17	07/30/16	% chg.	07/29/17	07/30/16	% chg.
Net Sales	1,687.6	1,631.8	3.4%	3,733.5	3,603.3	3.6%
Cost of Sales	1,063.9	1,014.1	4.9%	2,407.3	2,310.1	4.2%
Gross Profit	623.7	617.7	1.0%	1,326.2	1,293.2	2.6%
Selling, Gen. & Admin. Exp.	542.4	518.4	4.6%	1,105.9	1,039.2	6.4%
Depreciation & Amort.	37.7	41.0	(8.0%)	75.6	81.7	(7.5%)
Operating Income	43.6	58.3	(25.2%)	144.7	172.3	(16.0%)
Interest Expense, net	14.4	13.6	5.9%	28.3	24.4	16.0%
Income Before Taxes	29.2	44.7	(34.7%)	116.4	147.9	(21.3%)
Taxes	7.0	16.8	(58.3%)	35.2	54.2	(35.1%)
Net Income, as reported	22.2	27.9	(20.4%)	81.2	93.7	(13.3%)
Norecurring Item	(7.3)	0.0		(2.7)	2.6	
Non-GAAP Net Income	$14.9	$27.9	(46.6%)	$78.5	$96.3	(18.5%)
GAAP Diluted EPS	$0.22	$0.27	(18.2%)	$0.80	$0.90	(10.9%)
Non-GAAP Diluted EPS	**$0.15**	**$0.27**	(45.1%)	**$0.78**	**$0.93**	(16.1%)
Diluted Shares Outst.	101.5	104.3	(2.7%)	101.4	104.2	(2.7%)
As a % of Net Sales:						
Gross Profit	36.96%	37.85%	(90)	35.52%	35.89%	(37)
Selling, Gen. & Admin. Exp.	32.14%	31.77%	37	29.62%	28.84%	78
Depreciation & Amort.	2.23%	2.51%	(28)	2.02%	2.27%	(24)
Operating Income	2.58%	3.57%	(99)	3.88%	4.78%	(91)
Non-GAAP Net Income	0.88%	1.71%	(83)	2.10%	2.67%	(57)
Tax Rate	23.97%	37.58%	(1,361)	30.24%	36.65%	(641)

Source: GameStop Corp. Note: Fiscal year ends on Saturday closest to Jan. 31

Additional comments on recent results. The 2Q period continued recent company trends regarding the traditional videogame business, as sales in the new software and pre-owned categories declined 3.4% and 7.5%, respectively. This likely represented the growing acceptance of digital downloading by customers (rather than making store visits to buy physical discs) as well as a less potent game release schedule compared to the prior year period. On the hardware side, sales were boosted by the March 2017 release of a new gaming console, the Nintendo Switch. The device has been met with generally strong demand and favorable reviews, in our opinion. This likely boosted store traffic and helped generate a 1.9% increase in comparable store sales for the quarter (slightly negative in the U.S. but positive in international markets).

Reflective of GME's growth and diversification initiatives, the Technology Brands segment posted a 7.0% gain in sales and a 17.2% increase in gross profit. This segment includes stores such as *Spring Mobile* (authorized retailer of AT&T wireless services), *Simply Mac* (retailer of Apple products), and *Cricket* (pre-paid AT&T services and devices), as well as the wholly owned buymytronics.com online business (consumer electronics trade-in). The 2Q sales gain reflected more stores in operation. However, comparable store traffic for the Technology Brands businesses declined 9% year-over-year and comparable store gross profit declined 13%, as the handset upgrade cycle was weaker than expected.

The nascent Collectibles segment (recently 99 stores) continued on a growth trajectory, with 2Q sales increasing 36.1% and gross profit up 24.5%. This business includes licensed-based interactive toys, apparel, and pop culture collectibles sold online and in physical retail stores. The online effort includes Geeknet, a business acquired by GME in 2015.

The segments closely related to the videogame business (hardware, software, pre-owned games, accessories, and digital sales) collectively generated about 67% of 2Q gross profit, while the newer, faster growing businesses (including the Technology Brand stores) contributed the remainder. One year ago, the videogame businesses generated nearly 75% of gross profit. We expect the mix to continue to shift toward non-videogaming businesses over the next several years.

Exhibit 2
Segment Analysis (figures in millions except percentages)

	13 Weeks Ended			26 Weeks Ended		
	07/29/17	07/30/16	% chg.	07/29/17	07/30/16	% chg.
Sales Mix:						
New Videogame Hardware	$248.4	$216.4	14.8%	$638.3	$529.3	20.6%
New Videogame Software	369.3	382.2	(3.4%)	889.8	949.4	(6.3%)
Pre-owned & Value	501.8	542.6	(7.5%)	1,028.0	1,103.5	(6.8%)
Videogame Accessories	144.1	119.5	20.6%	320.2	282.2	13.5%
Digital	46.5	36.3	28.1%	90.6	79.1	14.5%
Technology Brands	188.3	175.9	7.0%	389.7	368.5	5.8%
Collectibles	122.5	90.0	36.1%	237.0	172.3	37.6%
Other	66.7	68.9	(3.2%)	139.9	119.0	17.6%
Total	$1,687.6	$1,631.8	3.4%	$3,733.5	$3,603.3	3.6%
Gross Profit Mix:						
New Videogame Hardware	$26.7	$30.0	(11.0%)	$64.8	$58.3	11.1%
New Videogame Software	81.8	98.1	(16.6%)	195.5	226.0	(13.5%)
Pre-owned & Value	225.6	244.0	(7.5%)	479.3	507.2	(5.5%)
Videogame Accessories	47.7	45.7	4.4%	103.6	102.8	0.8%
Digital	37.9	32.7	15.9%	74.0	69.7	6.2%
Technology Brands	138.9	118.5	17.2%	283.5	236.2	20.0%
Collectibles	43.2	34.7	24.5%	78.4	63.3	23.9%
Other	21.9	14.0	56.4%	47.1	29.7	58.6%
Total	$623.7	$617.7	1.0%	$1,326.2	$1,293.2	2.6%
Margin Analysis:			bp chg.			bp chg.
New Videogame Hardware	10.75%	13.86%	(311)	10.15%	11.01%	(86)
New Videogame Software	22.15%	25.67%	(352)	21.97%	23.80%	(183)
Pre-owned & Value	44.96%	44.97%	(1)	46.62%	45.96%	66
Videogame Accessories	33.10%	38.24%	(514)	32.35%	36.43%	(407)
Digital	81.51%	90.08%	(858)	81.68%	88.12%	(644)
Technology Brands	73.77%	67.37%	640	72.75%	64.10%	865
Collectibles	35.27%	38.56%	(8.5%)	33.08%	36.74%	(10.0%)
Other	32.83%	20.32%	1,251	33.67%	24.96%	871
Total	36.96%	37.85%	(90)	35.52%	35.89%	(37)

Source: GameStop Corp. Note: Fiscal year ends on Saturday closest to Jan. 31

Below the operating income line, the 2Q period had a negative impact from higher interest expense and positive impacts from a lower share count and a lower tax rate. We expect share repurchases to continue throughout the balance of this fiscal year.

Financial condition. The balance sheet remained in decent shape, in our view. Cash and equivalents at July 29, 2017 were $262.1 million. Inventories and receivables were at higher levels than one year ago, but not to levels of concern for us. There was $816.14 million in total debt, or 26% of total capitalization. Stockholders' equity at 2Q period end was $2.311 billion.

Business mix transition. In fiscal 2013, GME ended the year with 6,600 videogame stores and essentially no "technology-based" stores (smartphone and mobile devices retailer and reseller). Three years later, at fiscal 2016 year end, the company operated 5,927 videogame stores and 1,522 technology-based stores. We expect this mix to continue shifting in favor of the technology stores, including more *AT&T Wireless*/*Spring Mobile*, *Cricket Wireless*, and *Simply Mac* (Apple products) stores. We support this strategy as we believe there will generally be greater demand for mobile devices (new and used) than videogames over the long term. However, as noted in 2Q, the technology stores can be impacted by industry factors such as handset upgrade tendencies and anticipation for future products (especially new iPhone models).

Dividends. In early March 2017, GME announced a 2.7% increase to its quarterly dividend, raising the rate a penny to $0.38 per share. The annualized rate of $1.52 per share represents a payout ratio of 48% based on our FY17 EPS estimate of $3.20. The current yield is 7.8%. The company initiated dividends in 2012 and has raised the rate each year since, although we do not consider a raise in March 2018 a certainty. At this time, we consider the dividend well-covered by cash flow and believe management and the Board place a high priority on dividend policy.

Outlook. Management's financial guidance for FY17 was little changed. We believe this reflects a generally strong slate of videogame releases planned for 2H but also a slow handset upgrade cycle and higher expenses at the AT&T Wireless/Spring Mobile stores as they focus more on entertainment/media services such as DIRECTV. Total company sales are still expected to be in a range of +2% to -2% compared to FY16, while comparable store sales are expected to be flat to -5%. Diluted EPS are still expected in the $3.10-$3.40 range, the mid-point of which represents a 14% decline from the FY16 figure.

We have fine-tuned our estimates, which are featured in Exhibit 3. Our FY17 revenue estimate is raised by $105 million higher based primarily on 2Q results. Our annual EPS estimate is increased by a penny in a fine-tuning measure related to margins. We anticipate the company's transformation strategy (less videogames stores, more mobile device and collectible stores) progressing but at a declining pace following the aggressive build-up of the Technology Brand retail operation over the past year or so. We still advocate the pursuit of the transformation strategy, however.

We have also updated our FY18 estimates, which include a $125 million increase to our sales estimate mainly due to greater assumptions in the Collectibles business segment. Our EPS estimate is raised by $0.08 to $3.30 after updates to our expense and margin forecast along with a more aggressive assumption regarding share repurchases.

We project free cash flow of just over $300 million for FY17. This is after interest payments, taxes, and capital expenditures. This would give GME significant amounts available for dividends (we project $155 million in total payments), share repurchases (company spent $75 million last year), and other options such as debt reduction or cash build-up. A line of credit is available should acquisitions enter the picture.

Valuation. GME is currently trading at about 6x our estimate of forward twelve-month earnings. This is similar to the stock's median forward multiple over the past five years. We attribute the recent history of low valuations to several factors, including concerns about future distribution of videogames (i.e. a threat to GME's core physical goods business) and uncertainties about diversification attempts (deviating from core competencies and the pace of expected contributions).

Opinion. We maintain our Neutral rating on GME. We recognize the low stock valuation and high dividend yield; however, we have been disappointed in videogame software sales for several quarters and per-store profit contributions from the Technology Brand businesses have been a bit below our expectations.

We view GME as an important partner to videogame publishers, offering important distribution capabilities for physical goods. Navigating industry conditions has been challenging, in our view. The *Spring Mobile*, *Simply Mac*, *Cricket* and collectible merchandise stores add diversification, decent margins, and growth potential, in our view. However, the videogame business still represents the majority of revenues and profits at this point, and results there have been below our expectations for several years, with particular weakness in recent quarters. We believe the consumer trend toward digital purchasing continues to gain traction, which would seem to be a headwind for GME going forward despite ongoing attempts by the company to capture some of this business.

For income investors, we believe GME continues to have merit. The current yield of 7.8% considerably exceeds applicable industry, sector, and market yields. Importantly, we consider dividend coverage adequate at this time. The payout ratio is 48% based on our FY17 EPS estimate. In addition, projected total payments of $155 million for the current year compares to over $300 million in projected free cash flow. Finally, we note the recent cash balance of $262 million.

GME shares are down about 40% over the past twelve months compared to a 13% rise for the S&P 500, as investors have reacted to the challenges at hand. We do not anticipate much capital appreciation for the stock in the coming year, unless EPS can break from the current low or no growth conditions stemming from lower net income offset by fewer shares outstanding.

Asset value, and the related price-to-book value multiple, could offer some support to GME at current levels, in our view. However, future asset values could change to some degree should impairment charges (potentially those related to store rationalization) occur, as they did last year.

Suitability. Our Suitability rating on GME is 4 (on a 1-to-4 scale with 1=most conservative and 4=most aggressive). This reflects consumer buying behavior trends in a digital world, the related impact on GME's store traffic, and the company's integration of, and growth plans for, non-videogame businesses. Our rating also reflects a recent debt issue.

Risks. Competitive entry in the used game business and digital downloading of content by consumers have been common concerns among investors in the past. To date, management has not seen an adverse impact from competitive entry into the used game business. Digital downloading of videogames is likely to continue growing each year, in our view, thus causing pressure on the company's traditional physical goods business. GME and the industry's major game publishers continue to work together to develop the retailer's role in the marketing and selling of both physical and digital content.

Planned declines in the company's sizable videogame retailing store base with a concurrent increase in the smartphone/mobile device/satellite retailing business represents a change in focus from GME's background. There is no assurance that the company's acumen in the former will transfer to the latter.

Other risk factors associated with investments in GameStop include changes or delays in publishers' release schedules; relationships with publishers, distributors, and hardware manufacturers; lease terms for stores; cyclicality of industry sales; macroeconomic risk; dependence on holiday sales; ability to negotiate and integrate acquisitions; and geopolitical risks to international operations.

Exhibit 3
Consolidated Statements of Income (figures in millions except per share data and percentages)

	2014	2015	2016	*2017E*	*2018E*
Net Sales	$9,296.0	$9,363.8	$8,607.9	*$8,700.0*	*$8,625.0*
Cost of Sales	6,520.1	6,445.5	5,598.6	*5,683.7*	*5,606.3*
Gross Profit	2,775.9	2,918.3	3,009.3	*3,016.3*	*3,018.8*
Nonrecurring Items	2.2	4.6	33.8	*(6.0)*	*0.0*
SG&A Exp.	2,001.0	2,108.9	2,252.6	*2,302.0*	*2,304.0*
EBITDA	772.7	804.8	722.9	*720.3*	*714.8*
Deprec. & Amort.	154.4	156.6	165.2	*154.0*	*155.0*
Operating Income	618.3	648.2	557.7	*566.3*	*559.8*
Interest Inc. & Other (Exp.), net	10.0	23.0	53.0	*61.0*	*56.0*
Income Before Taxes	608.3	625.2	504.7	*505.3*	*503.8*
Provision for Taxes	215.2	222.4	151.5	*178.4*	*177.6*
Net Income, GAAP	393.1	402.8	353.2	*326.9*	*326.2*
Non-GAAP Adjustments, net	(0.7)	12.8	37.7	*(4.0)*	*0.0*
Net Income, Adjusted	$392.4	$415.6	$390.9	*$322.9*	*$326.2*
Diluted EPS, Adjusted	**$3.47**	**$3.90**	**$3.77**	***$3.20***	***$3.30***
Wtd. Diluted Shares Outst.	113.2	106.7	103.8	*100.8*	*98.8*
As a % of Net Sales					
Gross Profit	29.86%	31.17%	34.96%	*34.67%*	*35.00%*
SG&A Exp.	21.53%	22.52%	26.17%	*26.46%*	*26.71%*
EBITDA	8.31%	8.59%	8.40%	*8.28%*	*8.29%*
Operating Income	6.65%	6.92%	6.48%	*6.51%*	*6.49%*
Net Income, Adjusted	4.22%	4.44%	4.54%	*3.71%*	*3.78%*
Tax Rate	35.38%	35.57%	30.02%	*35.30%*	*35.25%*
Yr-Over-Yr Growth Rates:					
Net Sales	2.8%	0.7%	(8.1%)	*1.1%*	*(0.9%)*
Gross Profit	4.3%	5.1%	3.1%	*0.2%*	*0.1%*
EBITDA	0.5%	4.2%	(10.2%)	*(0.4%)*	*(0.8%)*
Operating Income		4.8%	(14.0%)	*1.5%*	*(1.2%)*
Net Income, Adjusted	10.2%	5.9%	(5.9%)	*(17.4%)*	*1.0%*
Diluted EPS, Adjusted	15.3%	12.4%	(3.3%)	*(14.9%)*	*3.1%*
Store Count:					
Videogame Stores, period end	6,211	6,064	5,927	5,810	5,700
Yr-over-yr store count % chg.	(5.9%)	(2.4%)	(2.3%)	(2.0%)	(1.9%)
Comparable-store sales % chg.	3.4%	4.3%	(11.0%)	(1.9%)	(3.0%)
Tech-based stores, period end	484	1,036	1,522	1,575	1,675
Collectibles stores, period end			86	115	140

Source: GameStop Corp. and Hilliard Lyons estimates   Note: Fiscal year ends on Saturday closest to Jan. 31

Additional information is available upon request.

Prices of other stocks mentioned: Apple Inc. - AAPL - $159.86 - Long-term Buy
AT&T Inc. - T - $37.99 - Buy
Nintendo Co. Ltd - NTDOY - $41.185

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings
1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	38	30%	11%	89%
Hold/Neutral	77	61%	8%	92%
Sell	11	9%	0%	100%

As of 9 August 2017

Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

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