HILLIARD LYONS

Entertainment & Leisure
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March 27, 2017

COMPANY UPDATE / ESTIMATE CHANGE / RATING CHANGE / SUITABILITY CHANGE

GameStop Corp.

GME — NYSE — Neutral-4

4Q About as Expected But FY17 Guidance Was Weak; Lowering Rating to Neutral, Suitability to 4

Key Metrics

GME - NYSE (as of 3/24/17)		$20.70
Price Target		N/A
52-Week Range		$20.10 - $33.72
Shares Outstanding (mil)		102.1
Market Cap. ($mil)		$2,113
3-Mo. Average Daily Volume		2,646,300
Institutional Ownership		99%
Total Debt/Total Capital (1/17)		27%
ROE (TTM ended 1/17)		18%
Book Value/Share (1/17)		$22.08
Price/Book Value		0.9x
Annual Dividend Rate & Yield	$1.52	7.3%
EBITDA Margin (TTM ended 1/17)		8.4%

EPS FY 1/31* (excludes nonrecurring items)

	2015	2016	Prior 2017E	Curr. 2017E
1Q	$0.68	$0.66		
2Q	$0.31	$0.27		
3Q	$0.54	$0.49		
4Q	$2.40	$2.38		
Year	$3.90	$3.77	$3.70	$3.20
P/E ~	5.3x	5.5x		6.5x

*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)

	2015	2016	Prior 2017E	Curr. 2017E
1Q	$2,061	$1,971		
2Q	$1,762	$1,632		
3Q	$2,016	$1,959		
4Q	$3,525	$3,045		
Year	$9,364	$8,608	$8,800	$8,550

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 7,535 total stores in 14 countries. This included 3,920 U.S. videogame stores, 2,007 international videogame stores, 1,522 technology brand stores, and 86 collectible stores.*

Investment Highlights

- **4Q results were down, but in line with recent guidance.** For the most important quarter of the fiscal year due to the holiday shopping season, net sales decreased 13.6% to $3.045 billion. As in recent quarters, the drop reflected considerable declines in the videogame store segment. Non-videogame segments such as Technology Brands (includes store brands AT&T Wireless/Spring Mobile, Simply Mac, and Cricket) and Collectibles (online and physical stores) grew and helped lead to an overall gross margin gain of 350 basis points. Diluted EPS excluding nonrecurring charges were $2.38, compared to $2.40 in the year ago period and our estimate of $2.27.

- **Guidance for fiscal 2017 was underwhelming, in our view.** This includes projected EPS of $3.10-$3.40, lower than our previous estimate of $3.70. In addition, free cash flow is expected to decline by $100 million from last year despite lower capital spending plans. We have reduced our financial estimates, yet do not have a great deal of confidence in our new figures due to ongoing challenges to GME's biggest business—physical videogame stores.

- **We are lowering our rating on GME to Neutral from Buy.** With a low valuation and high dividend yield, we have some attraction to the stock. However, the overriding factors in our downgrade are a change in direction for projected earnings (down rather than up), growing concern for the core videogame retailing business, our slightly less bullish view on the diversification strategy, and lower projected free cash flow for the current fiscal year. We consider the dividend, currently yielding 7.3%, adequately covered by cash flow. We have lowered our Suitability rating to 4 from 3 based on our latest views on company fundamentals and industry trends.

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			52 Weeks Ended		
	01/28/17	**01/30/16**	**% chg.**	**01/28/17**	**01/30/16**	**% chg.**
Net Sales	3,045.4	3,525.0	(13.6%)	8,607.9	9,363.8	(8.1%)
Cost of Sales	2,037.5	2,481.8	(17.9%)	5,598.6	6,445.5	(13.1%)
Gross Profit	1,007.9	1,043.2	(3.4%)	3,009.3	2,918.3	3.1%
Selling, Gen. & Admin. Exp.	646.3	613.9	5.3%	2,252.6	2,108.9	6.8%
Depreciation & Amort.	41.2	43.4	(5.1%)	165.2	156.6	5.5%
Asset Impairment Charges	33.8	4.0	745.0%	33.8	4.6	634.8%
Operating Income	286.6	381.9	(25.0%)	557.7	648.2	(14.0%)
Interest Expense, net	13.8	5.5	150.9%	53.0	23.0	130.4%
Income Before Taxes	272.8	376.4	(27.5%)	504.7	625.2	(19.3%)
Taxes	64.1	128.6	(50.2%)	151.5	222.4	(31.9%)
Net Income	208.7	247.8	(15.8%)	353.2	402.8	(12.3%)
GAAP Diluted EPS	$2.04	$2.36	(13.7%)	$3.40	$3.78	(9.9%)
Non-GAAP Diluted EPS	**$2.38**	**$2.40**	**(0.8%)**	**$3.77**	**$3.90**	**(3.3%)**
Diluted Shares Outst.	102.5	105.0	(2.4%)	103.8	106.7	(2.7%)
As a % of Net Sales:						
Gross Profit	33.10%	29.59%	350	34.96%	31.17%	379
Selling, Gen. & Admin. Exp.	21.22%	17.42%	381	26.17%	22.52%	365
Operating Income	9.41%	10.83%	(142)	6.48%	6.92%	(44)
Net Income	6.85%	7.03%	(18)	4.10%	4.30%	(20)
Tax Rate	23.50%	34.17%	(1,067)	30.02%	35.57%	(555)

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

Additional 4Q discussion. The 4Q period continued recent company trends and represented contrasts between the company's different business segments. Comparable-store sales for the videogame business decreased 16.3% in 4Q; this followed an 18.7% decline in 3Q. As noted in Exhibit 2, the videogame segments (hardware, software, and accessories) declined considerably in 4Q. Lower store traffic likely related to a continuation of industry trends (growing consumer preference for digital downloading vs. purchase of physical goods). Also, the videogame release slate was generally considered soft by historical standards.

Reflective of planned diversification efforts, the Technology Brands segment posted a 43.9% sales gain, with gross profit rising 57.6%. The 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 relatively new Collectibles segment continued on a growth trajectory, with 4Q sales increasing 27.8% and gross profit up 13.4%. This business includes licensed-based interactive toys 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 traditional videogame business (hardware, software, pre-owned games, accessories, and digital sales) collectively generated 73% of 4Q gross profit, while the newer, faster growing businesses (including the Technology Brand stores) contributed 27%.

Exhibit 2
Segment Analysis (figures in millions except percentages)

	13 Weeks Ended			52 Weeks Ended		
	01/28/17	01/30/16	% chg.	01/28/17	01/30/16	% chg.
Sales Mix:						
New Videogame Hardware	$583.0	$822.0	(29.1%)	$1,396.7	$1,944.7	(28.2%)
New Videogame Software	927.4	1,149.8	(19.3%)	2,493.4	2,905.1	(14.2%)
Pre-owned & Value	680.6	729.3	(6.7%)	2,254.1	2,374.7	(5.1%)
Videogame Accessories	238.5	288.7	(17.4%)	676.7	703.0	(3.7%)
Digital	57.2	60.7	(5.8%)	181.0	188.3	(3.9%)
Technology Brands	256.0	177.9	43.9%	814.0	534.0	52.4%
Collectibles	212.4	166.2	27.8%	494.1	309.7	59.5%
Other	90.3	130.4	(30.8%)	297.9	404.3	(26.3%)
Total	$3,045.4	$3,525.0	(13.6%)	$8,607.9	$9,363.8	(8.1%)
Gross Profit Mix:						
New Videogame Hardware	$58.6	$66.3	(11.6%)	$154.2	$175.5	(12.1%)
New Videogame Software	224.4	274.0	(18.1%)	600.4	689.3	(12.9%)
Pre-owned & Value	318.9	339.5	(6.1%)	1,044.1	1,114.5	(6.3%)
Videogame Accessories	82.8	103.6	(20.1%)	235.2	255.5	(7.9%)
Digital	50.8	49.9	1.8%	155.5	149.6	3.9%
Technology Brands	174.6	110.8	57.6%	554.6	306.6	80.9%
Collectibles	68.6	60.5	13.4%	171.6	116.6	47.2%
Other	29.2	38.6	(24.4%)	93.7	110.7	(15.4%)
Total	$1,007.9	$1,043.2	(3.4%)	$3,009.3	$2,918.3	3.1%
Margin Analysis:			bp chg.			bp chg.
New Videogame Hardware	10.05%	8.07%	199	11.04%	9.02%	202
New Videogame Software	24.20%	23.83%	37	24.08%	23.73%	35
Pre-owned & Value	46.86%	46.55%	30	46.32%	46.93%	(61)
Videogame Accessories	34.72%	35.89%	(117)	34.76%	36.34%	(159)
Digital	88.81%	82.21%	660	85.91%	79.45%	646
Technology Brands	68.20%	62.28%	592	68.13%	57.42%	1,072
Collectibles	32.30%	36.40%	(410)	34.73%	37.65%	(292)
Other	32.34%	29.60%	274	31.45%	27.38%	407
Total	33.10%	29.59%	350	34.96%	31.17%	379

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

Below the operating income line, GME had a negative impact from higher interest expense and positive impacts from a lower share count and a lower tax rate. Higher interest expense reflects a recent debt issue to help fund growth (primarily in the Technology Brands segment), while the share count drop reflects repurchases over the past twelve months. The company bought back 1.66 million shares in 4Q for $39.1 million, for an average purchase price of $23.56. About $170 million remains on the current repurchase authorization.

Financial condition. The balance sheet remained in decent shape, in our view. Cash and equivalents at January 28, 2017 were $669.4 million. Inventories were at a slightly lower level than one year ago, while receivables were slightly higher. There was $815.0 million in total debt, or 27% of total capitalization. This was above the year ago level due mainly to the issuance of senior notes in March 2016. Stockholders' equity at 4Q period end was $2.254 billion.

Financial outlook. We were surprised by financial guidance for FY17, which seemed to reflect a fair amount of caution or conservatism, or perhaps both. Total sales are expected to be in a range of +2% to -2% compared to FY16, whereas our previous estimate reflected a gain just over 2%. Comparable store sales are expected to be flat to down 5%. The mid-point of management's net income projection represents a 14% decline from the just completed year. Diluted EPS are expected in the range of $3.10-$3.40, the mid-point of which also represents a 14% decline from the FY16 figure.

We have fine-tuned our estimates, which are featured in Exhibit 3. Our key estimates are lower than our previous levels and are below the mid-points of management's guided ranges. This is a reflection of the company's transformation strategy (less videogames stores, more mobile device and collectible stores) unfolding at a slightly slower pace, and with lower effectiveness, than what we had originally anticipated. We still advocate the pursuit of the transformation strategy, however.

In FY17, we project free cash flow of $300 million, or $100 million below the FY16 level. 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.

New hardware. Sales of existing consoles are currently challenged by age (on the market for 3-4 years now) and lower price points. A new console from Nintendo, *Switch*, was released earlier this month and reviews have been pleasantly surprising, in our view. Of course, an ample supply of high quality games—some from Nintendo and some from other publishers—is needed for a console to succeed. Because physical machines require a purchase from a store (brick & mortar or online), GameStop store traffic could get a much-needed boost in this debut quarter for *Switch* (1Q of FY17). It remains to be seen, however, how consumers will react during the all-important holiday sales period in 4Q.

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. Non-physical gaming businesses (mainly the technology brand businesses and a pop culture collectible merchandise business) produced about 40% of GME's earnings in FY16 and are expected to represent over 50% by FY19.

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 next payment date at this rate is 3/28/17. The annualized rate of $1.52 per share represents a payout ratio of 48% based on our FY17 EPS estimate. The current yield is 7.3%. The company initiated dividends in 2012 and has raised the rate each year since. We consider the dividend well-covered by cash flow and believe management and the Board continue to place a high priority on dividend policy.

Valuation. GME is currently trading at 6.5x our reduced FY17 EPS estimate. GME's median forward multiple over the past five years is 8.9x. We attribute the more recent history of lower 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 are lowering our rating on GME to Neutral from Buy. This primarily reflects videogame store performance (recent and projected) below our expectations, and growth from non-videogame businesses slightly below our original expectations. Most all elements of the company's FY17 financial guidance were below our recent projections. This includes a forecasted decline in EPS compared to our previous expectation of an increase. In addition, we were disappointed in the FY17 free cash flow outlook being $100 million below last year, despite planned lower capital expenditures.

We view GME as an important partner to videogame publishers, offering powerful 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 bulk of revenues and profits at this point, and results there have been below our expectation 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 significant headwind for GME going forward.

For income investors, we believe GME continues to have merit. The current yield of 7.3% considerably exceeds applicable industry, sector, and market yields. Importantly, we consider dividend coverage adequate at this time. The payout ratio is 40% based on FY16 EPS and 48% based on our FY17 EPS estimate. In addition, projected total payments of $155 million for the current year compares to $300 million in projected free cash flow. Finally, we note the FY16 year-end cash & equivalents balance of $669 million. However, we do not anticipate much, if any, capital appreciation for the stock in the coming year. In fact, if future EPS continue to trend downward, we would expect share price weakness.

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 in FY16.

Suitability. Our Suitability rating on GME is lowered to 4 from 3 (on a 1-to-4 scale with 1=most conservative and 4=most aggressive). This reflects a change in the earnings trend—from our previous expectation of slight increases going forward to our current view of projected declines in the years ahead. This is based on ongoing changes in consumer buying behavior, the related impact on future store traffic trends, and a growing reliance on non-videogame operations. Our rating also reflects a recent debt issue to grow the non-videogame business.

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 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	1Q	2Q	3Q	4Q	2016	*2017E*
Net Sales	$9,296.0	$9,363.8	$1,971.5	$1,631.8	$1,959.2	$3,045.4	$8,607.9	*$8,550.0*
Cost of Sales	6,520.1	6,445.5	1,296.0	1,014.1	1,251.0	2,037.5	5,598.6	*5,535.0*
Gross Profit	2,775.9	2,918.3	675.5	617.7	708.2	1,007.9	3,009.3	*3,015.0*
Asset Impairment	2.2	4.6	0.0	0.0	0.0	33.8	33.8	*0.0*
SG&A Exp.	2,001.0	2,108.9	520.8	518.4	567.1	646.3	2,252.6	*2,300.0*
EBITDA	772.7	804.8	154.7	99.3	141.1	327.8	722.9	*715.0*
Deprec. & Amort.	154.4	156.6	40.7	41.0	42.3	41.2	165.2	*155.0*
Operating Income	618.3	648.2	114.0	58.3	98.8	286.6	557.7	*560.0*
Interest Inc. & Other (Exp.), net	10.0	23.0	10.8	13.6	14.8	13.8	53.0	*58.0*
Income Before Taxes	608.3	625.2	103.2	44.7	84.0	272.8	504.7	*502.0*
Provision for Taxes	215.2	222.4	37.4	16.8	33.2	64.1	151.5	*177.0*
Net Income, GAAP	393.1	402.8	65.8	27.9	50.8	208.7	353.2	*325.0*
Non-GAAP Adjustments	(0.7)	12.8	2.6	0.0	0.0	35.1	37.7	*0.0*
Net Income, Adjusted (exclud. nonrecurring items)	$392.4	$415.6	$68.4	$27.9	$50.8	$243.8	$390.9	*$325.0*
Diluted EPS, Adjusted	**$3.47**	**$3.90**	**$0.66**	**$0.27**	**$0.49**	**$2.38**	**$3.77**	***$3.20***
Wtd. Diluted Shares Outst.	113.2	106.7	104.2	104.3	103.7	102.5	103.8	*101.5*
As a % of Net Sales								
Gross Profit	29.86%	31.17%	34.26%	37.85%	36.15%	33.10%	34.96%	*35.26%*
SG&A Exp.	21.53%	22.52%	26.42%	31.77%	28.95%	21.22%	26.17%	*26.90%*
EBITDA	8.31%	8.59%	7.85%	6.09%	7.20%	10.76%	8.40%	*8.36%*
Operating Income	6.65%	6.92%	5.78%	3.57%	5.04%	9.41%	6.48%	*6.55%*
Net Income, Adjusted	4.22%	4.44%	3.47%	1.71%	2.59%	8.01%	4.54%	*3.80%*
Tax Rate	35.38%	35.57%	36.24%	37.58%	39.52%	23.50%	30.02%	*35.25%*
Yr-Over-Yr Growth Rates:								
Net Sales	2.8%	0.7%	(4.3%)	(7.4%)	(2.8%)	(13.6%)	(8.1%)	*(0.7%)*
Gross Profit	4.3%	5.1%	5.7%	6.4%	8.0%	(3.4%)	3.1%	*0.2%*
SG&A Exp.	5.7%	5.4%	8.7%	5.7%	8.0%	5.3%	6.8%	*2.1%*
EBITDA	0.5%	4.2%	(3.1%)	10.7%	8.5%	(22.9%)	(10.2%)	*(1.1%)*
Operating Income		4.8%	(8.0%)	12.8%	8.9%	(25.0%)	(14.0%)	*0.4%*
Net Income, Adjusted	10.2%	5.9%	(7.3%)	(15.7%)	(11.0%)	(3.1%)	(5.9%)	*(16.8%)*
Diluted EPS, Adjusted	15.3%	12.4%	(3.6%)	(13.4%)	(9.0%)	(0.7%)	(3.3%)	*(15.0%)*
Store Count:								
Videogame Stores, period end	6,211	6,064					5,927	5,775
Yr-over-yr store count % chg.	(5.9%)	(2.4%)					(2.3%)	(2.6%)
Comparable-store sales % chg.	3.4%	4.3%					(11.0%)	(3.5%)
Tech-based stores, period end	484	1,036					1,522	1,590
Collectibles stores, period end							86	120

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 - $140.64 - Long-term Buy
AT&T Inc. - T - $41.68 - Buy
Nintendo Co. Ltd - NTDOY - $30.22

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

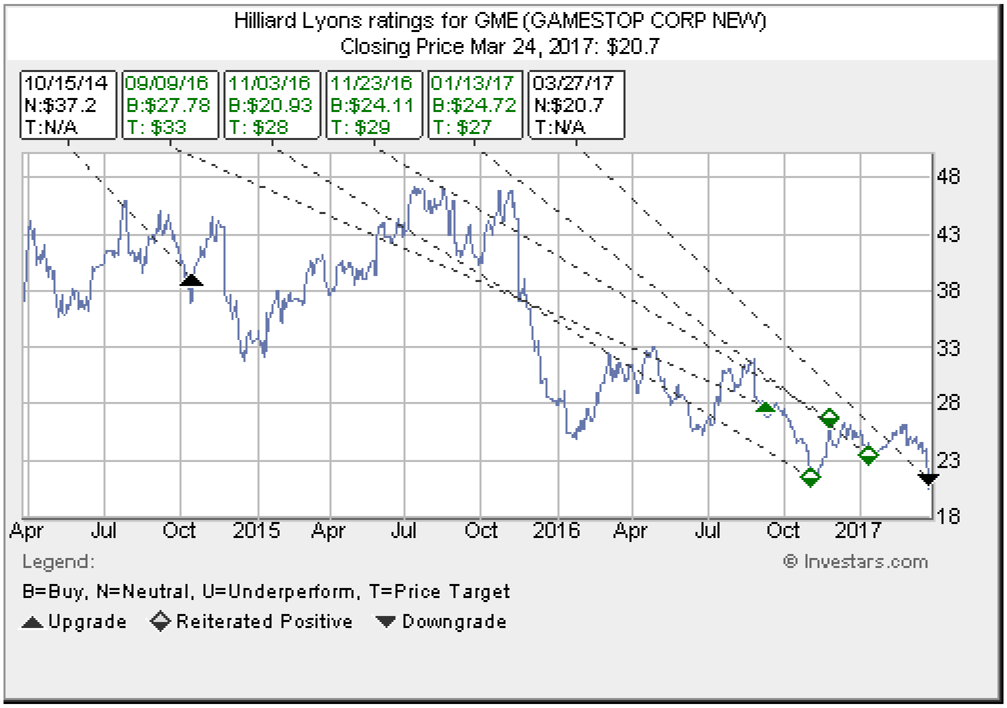
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe 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	35	29%	14%	86%
Hold/Neutral	71	59%	6%	94%
Sell	15	12%	7%	93%

As of 8 March 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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