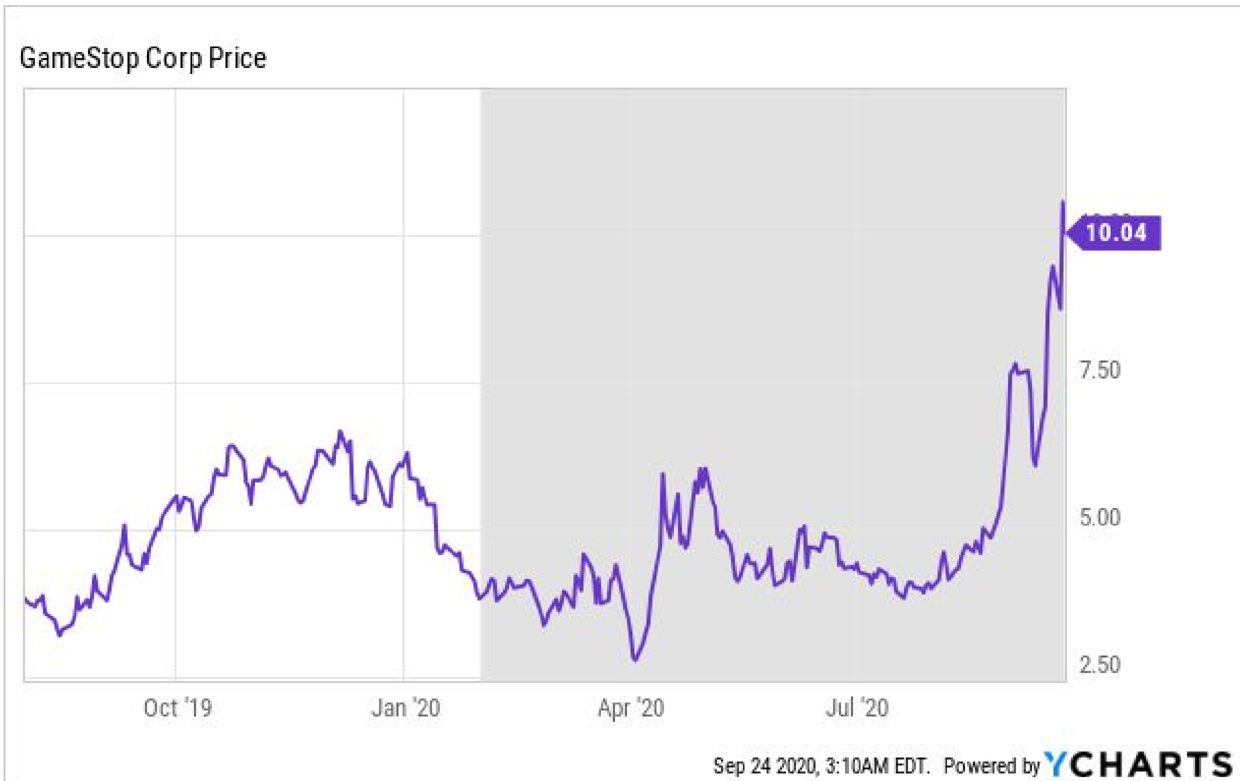
My Exit Strategy on GameStop stock

This is not the usual analysis. I'm only going to make research today since I want to publish the analysis on Seeking Alpha. I don't know if it will be accepted but you can't publish on Seeking Alpha and somewhere else.

What I'm going to do is share with you the research that I'm making on writing this article. This is legal. And at the same time, I'll make it more personal and how it applies to my portfolio. This is something that won't be possible on the Seeking Alpha article.



I started buying GameStop in September 2019 at about $4 a share and have been buying since then. I bought GameStop in the price range $3.25 - $6.14 with a cost basis of $4.64.

The main reason why I started to buy GameStop was because of the fundamentals

GameStop was trading under book value. It had more cash to buy the whole company and it didn't have much debt. A new console cycle was coming and the company could return money to shareholders. It was the definition of a cigar butt stock.

Then, we got a bonus. GameStop started buying back shares.

And now, more than 88% of shares outstanding of GameStop and 254% of float are being shorted. This can lead to a short squeeze.

There has been more good news about GameStop, mainly, investments from Ryan Cohen and Michale Burry.

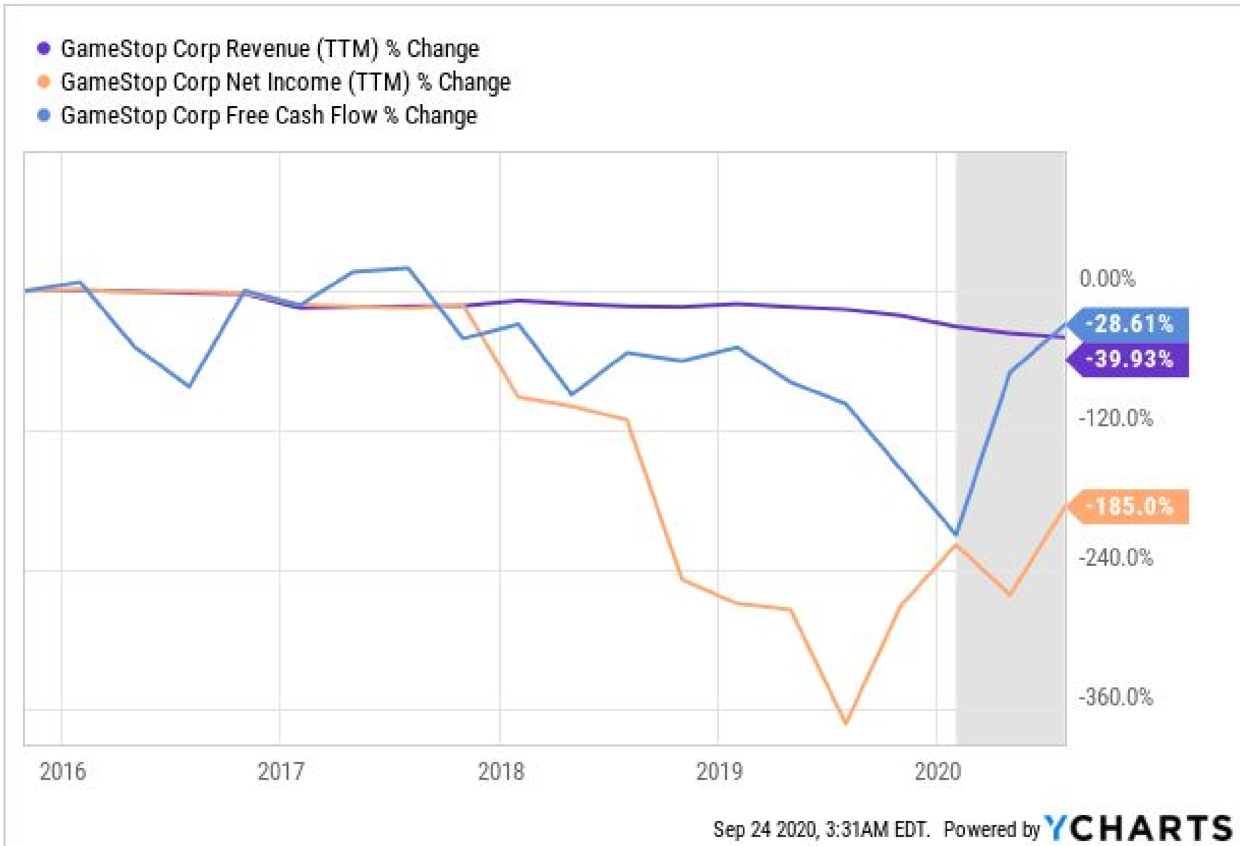
Making the argument that "GameStop is the next Blockbuster" is not accurate as Blockbuster never had so many catalysts playing in its favor as gameStop does.

That's one more reason to look at GameStop.

Now, there are in my opinion 6 different scenarios that can play out with GameStop

1. **Fast Bankruptcy**

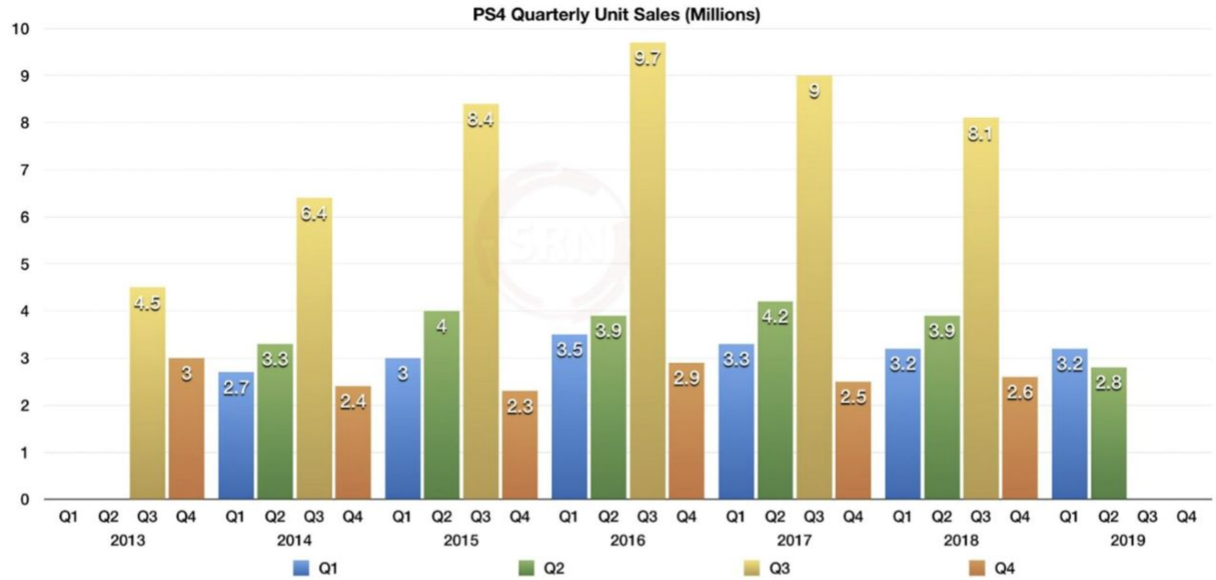
GameStop is a failing business as it failed to capitalize on the growth of online sales. Now, it has big competitors such as Walmart, BestBuy and Amazon. The sales of GameStop are in decline, so are the net income and free cash flow.



The company closed several of its stores and lowered its workforce by about 30%.

As we know, we're expecting a new console cycle for GameStop. But what if it doesn't work?

What if most people prefer to buy consoles without disks online. This is a possibility that we need to consider. Although both Microsoft and Sony have consoles with disk slots, this doesn't mean that they will sell.



Sony PlayStation 4 sales peaked in 2016.

Let’s have a look at the 2013, 2016 and 2019 10-K of GameStop. We will need to figure out how much money GameStop actually makes in a new console cycle.

	52 Weeks Ended February 1, 2014		53 Weeks Ended February 2, 2013		52 Weeks Ended January 28, 2012	
	Net Sales	Percent of Total	Net Sales	Percent of Total	Net Sales	Percent of Total
Net Sales:						
New video game hardware	$ 1,730.0	19.1%	$ 1,333.4	15.0%	$ 1,611.6	16.9%
New video game software	3,480.9	38.5%	3,582.4	40.3%	4,048.2	42.4%
Pre-owned and value video game products	2,329.8	25.8%	2,430.5	27.4%	2,620.2	27.4%
Video game accessories	560.6	6.2%	611.8	6.9%	661.1	6.9%
Digital	217.7	2.4%	208.4	2.3%	143.0	1.5%
Mobile and consumer electronics	303.7	3.4%	200.3	2.3%	12.8	0.1%
Other	416.8	4.6%	519.9	5.8%	453.6	4.8%
Total	$ 9,039.5	100.0%	$ 8,886.7	100.0%	$ 9,550.5	100.0%

	52 Weeks Ended February 1, 2014		53 Weeks Ended February 2, 2013		52 Weeks Ended January 28, 2012	
	Gross Profit	Gross Profit Percent	Gross Profit	Gross Profit Percent	Gross Profit	Gross Profit Percent
Gross Profit:						
New video game hardware	$ 176.5	10.2%	$ 101.7	7.6%	$ 113.6	7.0%
New video game software	805.3	23.1%	786.3	21.9%	839.0	20.7%
Pre-owned and value video game products	1,093.9	47.0%	1,170.1	48.1%	1,221.2	46.6%
Video game accessories	220.5	39.3%	237.9	38.9%	251.9	38.1%
Digital	149.2	68.5%	120.9	58.0%	66.5	46.5%
Mobile and consumer electronics	65.1	21.4%	41.3	20.6%	3.5	27.3%
Other	150.6	36.1%	193.3	37.2%	183.8	40.5%
Total	$ 2,661.1	29.4%	$ 2,651.5	29.8%	$ 2,679.5	28.1%

	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%

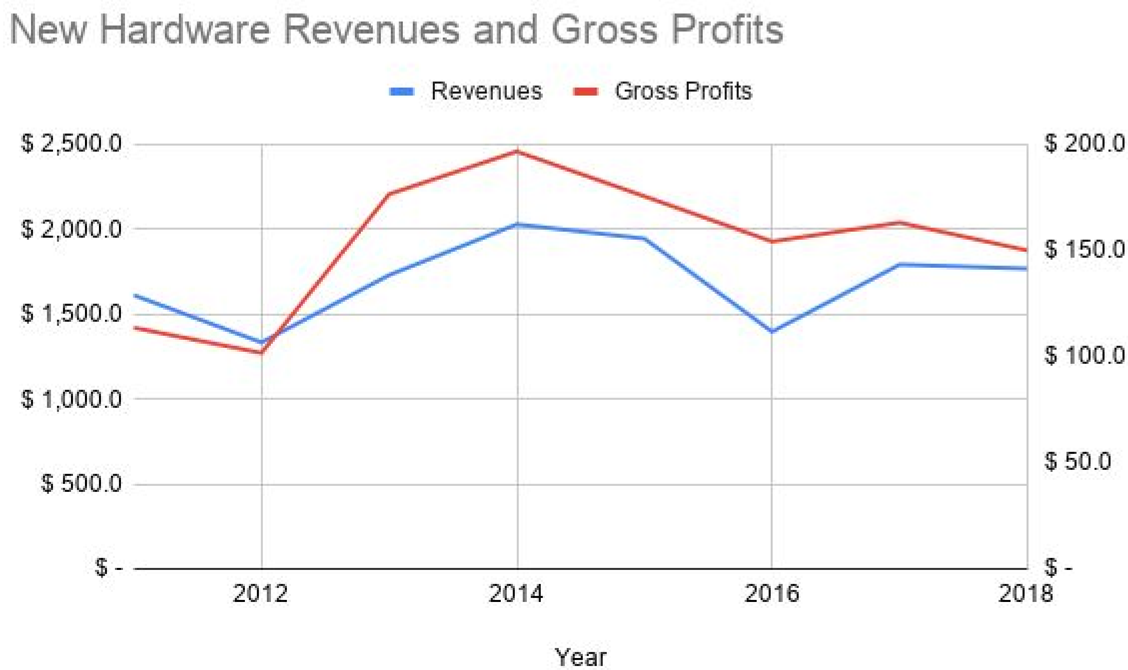
	Fiscal Year 2016		Fiscal Year 2015		Fiscal Year 2014	
	Gross Profit	Gross Profit Percent	Gross Profit	Gross Profit Percent	Gross Profit	Gross Profit Percent
New video game hardware(1)	$ 154.2	11.0%	$ 175.5	9.0%	$ 196.6	9.7%
New video game software	600.4	24.1	689.3	23.7	716.9	23.2
Pre-owned and value video game products	1,044.1	46.3	1,114.5	46.9	1,146.3	48.0
Video game accessories	235.2	34.8	255.5	36.3	246.1	37.7
Digital	155.5	85.9	149.6	79.4	152.0	70.3
Technology Brands(2)	554.6	68.1	306.6	57.4	169.1	51.5
Collectibles	171.6	34.7	116.6	37.6	31.9	42.1
Other(3)	93.7	31.5	110.7	27.4	117.0	22.7
Total	$ 3,009.3	35.0%	$ 2,918.3	31.2%	$ 2,775.9	29.9%

	Fiscal Year 2018		Fiscal Year 2017		Fiscal Year 2016	
	Net Sales	Percent of Net Sales	Net Sales	Percent of Net Sales	Net Sales	Percent of Net Sales
New video game hardware(1)	$ 1,767.8	21.3%	$ 1,791.8	21.0%	$ 1,396.7	17.5%
New video game software	2,449.7	29.6	2,582.0	30.2	2,493.4	31.3
Pre-owned and value video game products	1,866.3	22.5	2,149.6	25.2	2,254.1	28.3
Video game accessories	956.5	11.5	784.3	9.2	676.7	8.5
Digital	194.0	2.3	189.2	2.2	181.0	2.3
Collectibles	707.5	8.5	636.2	7.4	494.1	6.2
Other(2)	343.5	4.3	414.0	4.8	469.0	5.9
Total	$ 8,285.3	100.0%	$ 8,547.1	100.0%	$ 7,965.0	100.0%

	Fiscal Year 2018		Fiscal Year 2017		Fiscal Year 2016	
	Gross Profit	Gross Profit Percent	Gross Profit	Gross Profit Percent	Gross Profit	Gross Profit Percent
New video game hardware(1)	$ 150.0	8.5%	$ 163.1	9.1%	$ 154.2	11.0%
New video game software	525.6	21.5	590.3	22.9	600.4	24.1
Pre-owned and value video game products	810.4	43.4	977.1	45.5	1,044.1	46.3
Video game accessories	312.5	32.7	255.0	32.5	235.2	34.8
Digital	171.6	88.5	162.4	85.8	155.5	85.9
Collectibles	233.3	33.0	208.2	32.7	171.6	34.7
Other(2)	104.7	30.5	128.8	31.1	138.9	29.6
Total	$ 2,308.1	27.9%	$ 2,484.9	29.1%	$ 2,499.9	31.4%

We can see that software sales have been in constant decline, from 2011 to 2018, a decline of nearly 40%. What interests us are the hardware. That's how we will better understand the console cycle.

Year	2011	2012	2013	2014	2015	2016	2017	2018
Revenues	$ 1,611.6	$ 1,333.4	$ 1,730.0	$ 2,028.7	$ 1,944.7	$ 1,396.7	1791.8	1767.8
Gross Profits	$ 113.6	$ 101.7	$ 176.5	$ 196.6	$ 175.5	$ 154.2	163.1	150
Gross Margins	7.05%	7.63%	10.20%	9.69%	9.02%	11.04%	9.10%	8.49%



Although the sales of PS4 peaked in 2016, the sales of GameStop new hardware peaked in 2014, an increase of 52% from 2012 and an increase of 93% in gross profits. That's good but it is not something that lasts long term, hence the cyclical nature of the business.

It is possible that this year, it will be worse and the company may not generate enough free cash flow to meet its obligations. Amazon was not the behemoth it is today back in 2013.

	Payments Due by Fiscal Period						
	Total	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Thereafter
Operating leases	$ 846.2	$ 268.5	$ 184.8	$ 129.8	$ 93.0	$ 65.7	$ 104.4
Purchase obligations(1)	463.5	463.5	—	—	—	—	—
2021 Senior Notes	421.4	—	421.4	—	—	—	—
Interest payments on senior notes	42.6	28.4	14.2	—	—	—	—
Total(2)	$ 1,773.7	$ 760.4	$ 620.4	$ 129.8	$ 93.0	$ 65.7	$ 104.4

The company was able to restructure its debt, converting part of the 6.750% Senior Notes due 2021 into 10.00% Senior Notes due 2023.

LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	$ 256.4	$ 368.3	$ 380.8
Accrued liabilities and other current liabilities	580.7	593.7	617.5
Current portion of operating lease liabilities	218.8	240.3	239.4
Short-term debt, including current portion of long-term debt, net	221.3	—	—
Borrowings under revolving line of credit	35.0	—	—
Liabilities held-for-sale	—	14.5	—
Total current liabilities	1,312.2	1,216.8	1,237.7
Long-term debt, net	215.9	419.1	419.8
Operating lease liabilities	475.5	523.9	529.3
Other long-term liabilities	19.3	18.4	21.4
Total liabilities	2,022.9	2,178.2	2,208.2
Commitments and contingencies (Note 7)			
Stockholders' equity:			
Class A common stock — $.001 par value; 300 shares authorized; 65.2, 90.5 and 64.3 shares issued and outstanding	0.1	0.1	0.1
Additional paid-in capital	2.9	—	—
Accumulated other comprehensive loss	(63.9)	(75.1)	(78.8)
Retained earnings	413.2	884.7	690.2
Total stockholders' equity	352.3	809.7	611.5
Total liabilities and stockholders' equity	$ 2,375.2	$ 2,987.9	$ 2,819.7

The company has only $221.3 million to repay next year. We have $218.8 million in operating lease liabilities and $580.7 million in accrued liabilities and others. In total, the current liabilities of GameStop are $1.312 million.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except par value per share)

	August 1, 2020	August 3, 2019	February 1, 2020
ASSETS			
Current assets:			
Cash and cash equivalents	$ 735.1	$ 424.0	$ 499.4
Receivables, net	83.1	122.4	141.9
Merchandise inventories, net	474.6	948.9	859.7
Prepaid expenses and other current assets	87.1	143.2	120.9
Assets held-for-sale	—	29.1	11.8
Total current assets	1,379.9	1,667.6	1,633.7
Property and equipment, net	219.7	312.0	275.9
Operating lease right-of-use assets	689.0	769.7	767.0
Deferred income taxes	29.2	157.8	83.0
Other noncurrent assets	57.4	80.8	60.1
Total assets	$ 2,375.2	$ 2,987.9	$ 2,819.7

The good news is that GameStop has now enough cash to repay a good portion of the current obligations.

For this reason, the fast bankruptcy scenario of GameStop is unlikely.

GameStop has been able to really change their business in recent years by lowering SG&A and being more concentrated. According to an article by Thinknum, For every GameStop in the world, there are 2 other GameStops within 5 miles, on average, and there are 6.2 other GameStops within 10 miles. They have been closing many unprofitable stores and from the last conference call, this has been a good decision since almost 40% of the sales from the closed stores have been transferred online and to nearby physical stores, which is enough for these sales to be profitable again.

What about GameStop not going bankrupt in the coming year but going bankrupt by the end of this new console cycle?

2. **Slow Bankruptcy**

Even if GameStop survives this console cycle, it may not survive the next since the revolution is coming. In 7 years, Sony and Microsoft may no longer launch consoles with disk drives, if they launch any console at all. We can already see a shift towards cloud gaming with PlayStation Now, xCould from Microsoft , NVidia GeForce Now, Google Stadia, and recently announced by Amazon, Luna.

The days of buying physical games are over.

Right now, many gamers still prefer physical games because of storage and bandwidth limitations on the diskless consoles but technology is advancing at a fast rate and this may not be a problem in 7 years.

The only people who would be shopping at GameStop would be collectors.

GameStop will have about $216 million in debt to repay in 2023. After that, if the business keeps failing, they will most probably require new debt issuance.

The only way that GameStop avoids this disaster is if the business radically changes.

One of these attempts is through the experimental new concept stores, which is more about experience than selling video games. The new stores allow gamers to try new games, organize tournaments, etc.

Another way that GameStop can avoid a slow bankruptcy is that it goes online but then, Amazon will still represent a challenge.

With so many activist investors involved in GameStop, Michael Burry, Hestia Capital, Permit Capital and Ryan Cohen, it is possible that they will try to change the business for the better, in other words, rebooting it.

3. Reboot

How do you reboot a company with a failing business model? One thing you could do is bring more qualified people on the leadership team and the board. A reboot of the company is hard but if done properly, it can make it last multiple decades. I'm not going to speculate about what should be done. This is the job of the management.

Paul Raines was CEO of GameStop from 2010 to January 2018 until he resigned for health issues (he passed away in March 2018). Since then, there has been a leadership crisis at the head of the company as they had 4 CEOs in one year until George Sherman took over in March 2019. CFO Jim Bell joined the team in June 2019.

It is not only the senior management of the company that changed but also the board of directors.

9 out of the 10 board members joined in the last three years. Among the board members we have William Simon, who has been the CEO of Walmart US and Reginal Fils-Amme, who was the COO of Nintendo America, The GameStop that has been in decline since 2008 is no longer the same GameStop today. There are more qualified leaders. The other good news is that the insiders have skin in the game owning about 14% of the company collectively.

Even with these recent changes the leadership of GameStop had to face constant pressures from activist investors. In August 2019, Michael Burry wrote a letter to the board asking them to buyback shares. They heeded to his advice and GameStop bought back 35% of the shares outstanding in less than a year. Recently, Ryan Cohen, the founder of Chewy (who sold Chewy to Petsmart in 2017), bought about 10% of GameStop and he has indicated that he wants to have an active role in the company. James Symancyk, (CEO of Petsmart) and Carrie Teffner (former CFO of Petsmart) are on the board. Is this a coincidence that three people who worked together before are now owners and directors of GameStop or is there some future activism that we can expect?

Earlier this year, there was a proxy fight between the board and two hedge funds, Hestia Capital and Permit Capital, who wanted to nominate two new board members. These two hedge funds owned about 7% of GameStop. The two hedge funds won. During that period, the stock price of GameStop doubled. Was it because Wall Street liked the new board members? No, it was more because shares had to be recalled for the vote and at some point more than 95% of the shares outstanding of GameStop were being shorted. This proxy fight triggered a short squeeze. But this short squeeze is nothing compared to what lays ahead.

4. Short Squeeze

88% of shares outstanding and 254% of float of GameStop are being shorted. If someone shorted 1 million shares of gameStop 5 years ago, it would have been 1.14% of float. Sooner or later, the short sellers will need to buy the shares to take their profits (a nice 75% before taxes & fees). Buying 1 M shares today will be 4.48% of float.

The whole premise of short selling is that you eventually need to buy back the shares and if we can avoid the fast bankruptcy or the company has a successful reboot, the shares will be going up as new investors try to ride the wave, the short sellers will be forced to cover their position leading to even higher prices in a positive feedback loop. A short squeeze seems inevitable with so many active players owning the stock.

How do you compete with that? In theory, they could all work together and recall their shares to vote on a particular subject and trigger a short squeeze in the process.

A short squeeze happened during the last console cycle. In 2012, about 75% of the float of GameStop was being shorted and in about two years, the float short percentage fell to 20%. This led to a gain of over 250% in the stock price. This time, if a short squeeze happens, it will be even worse (if you're a short seller) as 254% of float, that's not easy to cover. It was however, just a pump and dump action from Wall Street, as once the short squeeze was over, the shares were being heavily shorted again

5. **Pump and Dump**

The aim of activist investors is to return money to shareholders. We have seen Michael Burry convincing the board to buy back shares. One of the arguments that the board put against the nominations of the directors during the proxy fight was that these hedge funds are only looking for short term capital gain and not the long-term success of the company. This is a scenario that we need to consider since most people on Wall Street are looking for capital gain, even the long-term value investors, at some point, they will sell a stock when it can no longer return money to shareholders. The "Buy and Hold Forever" philosophy doesn't really apply to GameStop, unless the company really has a successful reboot and they can even pay a dividend in the future. It is possible, therefore, that GameStop business is saved but it remains under the caprice of Wall Street and undergoes more of these pump and dump cycles. Unless, the company goes private and Wall Street cannot trade it anymore.

6. **Privatization**

Ryan Cohen hired Christoper P. Davis, a lawyer expert in M&A and activism, to file his SEC filings for GameStop. We have already said that Ryan Cohen has worked closely with some of the board members of GameStop before. Is it possible that Ryan Cohen wants to take GameStop private?

Taking GameStop private seems to be the best solution for all parties. Ryan Cohen has never done activism before and he seems to be more interested in the business future. With the lack of liquidity in the shares, he won’t be able to have a majority ownership and will always have to face activists or the short sellers. Taking the private, he can reinvent it, and do what he did with Chewy again, that is, compete successfully with Amazon.

The hedge funds would want to return money to their clients. Shares will be recalled to take the company private and this will trigger a short squeeze and the activist investors can exit with very good profits.

As for the insiders, they don’t have to worry about the quarterly reports anymore and try to make Wall Street happy.

There will be some challenges before the company can go private. Financing will be one of them since it will need to be at a price where everybody is happy and Permit Capital and Hestia Capital bought GameStop at quite high prices. Will Ryan Cohen be able to convince a bank to finance the privatization of the most hated stock on Wall Street? The SEC might also get involved as the short sellers will have a difficulty in finding shares to cover their positions.

Which of these scenarios is the most likely? In my opinion, we will have a combination of some of these scenarios. The short squeeze, reboot and privatization can happen at the same time.

My average buying price on GameStop is $4.64 and I think that GameStop at the current time has an intrinsic value of $20. That doesn’t mean that I’ll sell if the stock price reaches $20 because the stock price can still go higher because of the short squeeze. I believe the probability of a short squeeze happening is 90%.

If the company is going private, which I believe is 40% probable, then, we will need to see if there’s the possibility of making money by arbitrage.

Right now, we need to follow the situation very closely. There are going to be more changes in this stock. I’ll keep you updated.

27th of September 2020