I have been holding GameStop (GME) for more than a year on the basis that the new console cycle was coming and GameStop was massively undervalued and qualified as a cigar butt stock. The company was trading under book value and its cash reserve was bigger than the market cap. However, over this past year, a lot changed in the company. There have been some activist investors such as Michael Burry and recently Ryan Cohen who invested in GameStop. The company bought back 35% of shares. There was a proxy fight in June and now GameStop is one of the most shorted stocks in history and could undergo a short squeeze.

Short squeezes are in the realm of technical analysis and personally, I am a fundamental analyst but this one can't be ignored.

There are six possible scenarios of what may happen to GameStop (both the company and the stock) in the coming months and we need to have a look at each one of them.

1. Fast Bankruptcy

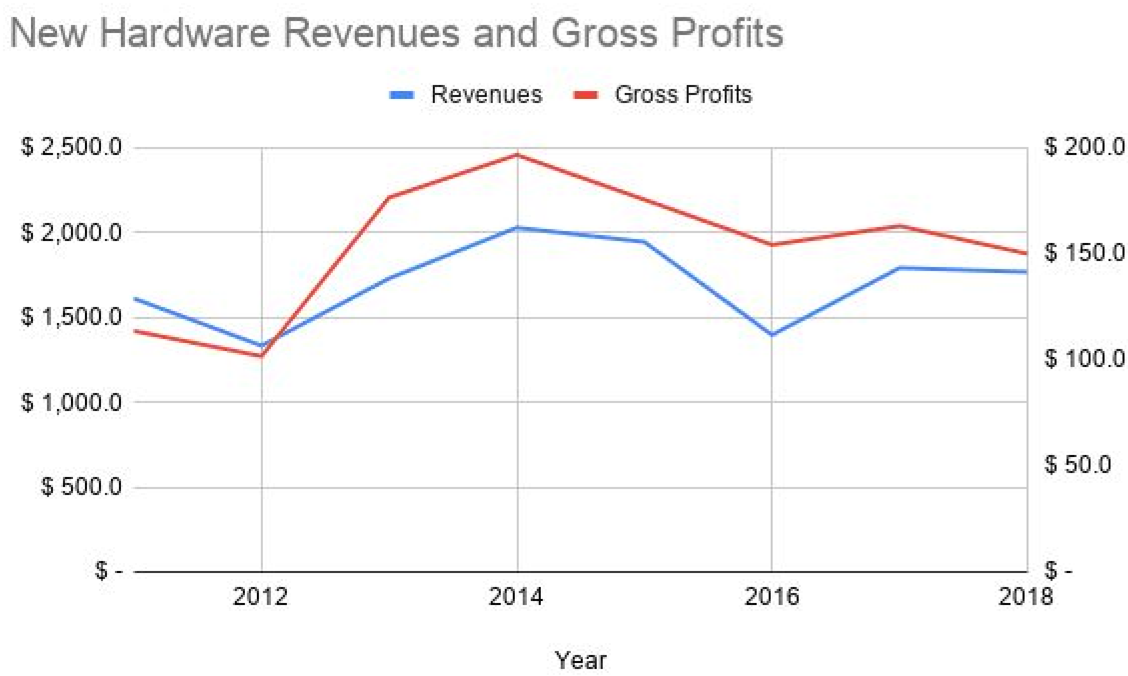
GameStop is a failing business as it failed to capitalize on the growth of online sales. Now, it has big competitors such as Walmart, Best Buy and Amazon. The sales of GameStop are in decline, so are the net income and free cash flow. In the last five years, the revenues fell by 28% while free cash flow fell by 40%.

In response to this precarious situation, GameStop closed several of its worst performing stores and laid off 30% of its workforce during that period.

This is, however, not the first time that GameStop has been in such a situation. The business is cyclical and depends a lot on console cycles. This November, Sony is launching their new PlayStation and Microsoft their new Xbox. What if this time GameStop fails to recover?

There is the possibility that most gamers decide to buy their new consoles online or at bigger stores such as Best Buy or Walmart instead of GameStop. In this case, GameStop may not recover and go bankrupt in the next 12 months.

To understand how likely this scenario is, we will need to look at the last console cycle, namely at the New Video Game Hardware business segment of GameStop.



Source: GameStop 10-K forms and author's own calculations

The Xbox One and PlayStation 4 were launched in November 2013 with sales of the PlayStation 4 peaking in 2016. The sales of GameStop New Video Game Hardware peaked in 2014, an increase of 52% from 2012 and an increase of 93% in gross profits. From then, both sales and gross profits from New Hardware declined, hence the cyclical nature of the business. Also, important to note is that GameStop's main revenue segment is New Video Game Software, which saw a constant decline of 40% from 2011 to 2018 and is still declining.

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

Recently, GameStop was able to restructure its debt, converting part of the 6.75% Senior Notes due 2021 into 10.00% Senior Notes due 2023. From the last 10-Q, we can see that GameStop 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.

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

Source: GameStop 2Q20 10-Q form

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

	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

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, reboot 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 pressure 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 and they 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

101.9% of shares outstanding and 292.5% of float of GameStop are being shorted. The NYSE just put GameStop on the Threshold Securities list as the stock violates SEC Regulations SHO, with more than 100% of shares short. Many of these shares are leveraged and the market makers, dealers and brokers have 13 days to cover the extra shorts. However, this happened earlier this year and didn't trigger any big short squeeze.

Source: Ycharts

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 million 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. 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.

Souce: Ycharts

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 292% 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 Christopher 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. Justin Dopierala recently wrote a Seeking Alpha article on the subject.

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.

The Future of GameStop

Source: Ychart

The future of GameStop is still uncertain. Although, it is unlikely that the company will go bankrupt in the coming months, looking at the performance of the stock in the long-term, it seems that Wall Street is looking for an imminent bankruptcy.

Michael Burry, Ryan Cohen and all the other activist investors are certainly interested in saving the company or at least, saving the stock.

There is so much happening so quickly with GameStop (both the company and stock) that I believe that it will be in future investing textbooks. Whether you're long, short or just an observer, this is a stock to be followed very closely.

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30th of September 2020