GameStop 3Q 2019

GameStop had very disappointing earnings and the stock fell by about 15% during after-market trading hours.

I started buying GameStop a few months ago, you can find the full analysis of GameStop here: https://ishfaaqpeerally.teachable.com/courses/662813/lectures/11816947 and the main thesis I had for buying GameStop was this:

GameStop is a cigar-butt stock. This company's business is dying but it has a really good balance sheet and the market is undervaluing the stock price. Next year, new consoles are coming, and these will certainly increase sales. Moreover, GameStop is buying back shares and they could buy back a large portion of the company and inflate the price.

But now, things seem very bad for this company. Let's have a look at the earning report to see the real numbers.

Third Quarter Results

GameStop's third quarter total global sales decreased 25.7% (24.7% in constant currency) to $1.4 billion, driven by a consolidated comparable store sales decrease of 23.2%.

- New hardware sales decreased 45.8%, reflecting anticipated next generation console launches in 2020.
- New software sales decreased 32.6%, with growth in Nintendo Switch software titles more than offset by weaker title launches across other consoles in the quarter compared to last year.
- Accessories sales decreased 13.4%.
- Pre-owned sales declined 13.3% with declines in hardware and software.
- Collectibles sales increased 4.3%, with continued growth in both domestic and international stores.

There has been a vast decline in sales across all their business segments except for collectibles. Collectibles represent only 11.2% of the total sales. Therefore, there's nothing to be happy about.

Before we go any further, let's just mention that it was expected that sales would go down as gamers are not interested in the current consoles. They are all waiting for the next generation of consoles next year.

GameStop's third quarter GAAP net loss was ($83.4) million, or ($1.02) per diluted share, compared to net loss of ($488.6) million, or ($4.78) per diluted share, in the prior-year quarter, which included the Spring Mobile business. Third quarter fiscal 2019 results include charges of $43.0 million, or $0.52 per diluted share, which included non-cash asset impairment charges, tax adjustments, transformation costs and other items. Third quarter fiscal 2018 results included non-operating, non-cash intangible asset impairment charges of $587.5 million, primarily related to goodwill.

Excluding the $43.0 million of impairment charges and other items, GameStop's adjusted net loss from continuing operations for the third quarter was ($40.2) million or ($0.49) per diluted share, compared to net income from continuing operations of $50.0 million, or $0.49 per diluted share, in the prior-year quarter.

Obviously, the earnings were down too. If compared to 3Q 2018, the loss seems smaller, that's because there was a large impairment of goodwill last year. Now the company doesn't have any goodwill, so we should not worry too much about that.

Capital Allocation Update

During the quarter, the company repurchased 22.6 million shares of its common stock, for $115.7 million, or an average price of $5.11 per share, bringing the year-to-date repurchase activity to $178.6 million for 34.6 million shares, or 34% of the shares outstanding, at an average price of $5.14 per share. As of the end of the fiscal third quarter, the company had 67.8 million shares outstanding. The company remains committed to opportunistically returning excess capital to shareholders as it continues to execute on its strategic initiatives to position the Company for the long term.

The company repurchased a large portion of its shares and it still has $184 millions worth of shares to repurchase under the current program. That's 36% of the company. If the stock price keeps falling, they will keep doing this.

As previously disclosed, during fiscal 2019, the company has reduced its outstanding debt by $401.7 million and has $419.4 million of long-term debt remaining on the balance sheet at quarter end.

GameStop also repaid some of their loan. This is something I was hoping they would do as I mentioned in this video.

2019 Outlook

The company is providing the following updated guidance for full fiscal year 2019:

Comparable Store Sales	A decline in the high-teens
Adjusted (Non-GAAP) Earnings Per Share (diluted)*	$0.10 to $0.20
Capital Expenditures	$80 million to $85 million

**A reconciliation of non-GAAP forward-looking projections to GAAP financial measures is not available as the nature or amount of potential adjustments, which may be significant, cannot be determined at this time.*

What about the outlook? Looks bad

Let’s look at the income statement:

	13 weeks ended November 2, 2019	13 weeks ended November 3, 2018
Net sales	$ 1,438.5	$ 1,935.4
Cost of sales	997.4	1,377.2
Gross profit	441.1	558.2
Selling, general and administrative expenses	451.8	463.6
Depreciation and amortization	23.6	25.0
Goodwill impairments	—	557.3
Asset impairments	11.3	30.2
Operating loss	(45.6)	(517.9)
Interest expense, net	6.0	13.0
Loss from continuing operations before income taxes	(51.6)	(530.9)
Income tax expense (benefit)	31.6	(24.0)
Net loss from continuing operations	(83.2)	(506.9)
(Loss) income from discontinued operations, net of tax	(0.2)	18.3
Net loss	$ (83.4)	$ (488.6)
Basic (loss) earnings per share:		
Continuing operations	$ (1.01)	$ (4.96)
Discontinued operations	—	0.18
Basic loss per share	$ (1.02)	$ (4.78)
Diluted (loss) earnings per share:		
Continuing operations	$ (1.01)	$ (4.96)
Discontinued operations	—	0.18
Diluted loss per share	$ (1.02)	$ (4.78)
Dividends per common share	$ —	$ 0.38
Weighted-average common shares outstanding:		
Basic	82.1	102.2
Diluted	82.1	102.2

		39 weeks ended November 2, 2019		39 weeks ended November 3, 2018
Net sales	$	4,271.9	$	5,222.3
Cost of sales		2,960.5		3,663.0
Gross profit		1,311.4		1,559.3
Selling, general and administrative expenses		1,341.7		1,361.2
Depreciation and amortization		69.3		80.5
Goodwill impairments		363.9		557.3
Asset impairments		11.3		30.2
Operating loss		(474.8)		(469.9)
Interest expense, net		20.7		40.6
Loss from continuing operations before income taxes		(495.5)		(510.5)
Income tax (benefit) expense		(6.2)		15.8
Net loss from continuing operations		(489.3)		(526.3)
(Loss) income from discontinued operations, net of tax		(2.6)		41.0
Net loss	$	(491.9)	$	(485.3)
Basic (loss) earnings per share:				
Continuing operations	$	(5.16)	$	(5.16)
Discontinued operations		(0.03)		0.40
Basic loss per share	$	(5.19)	$	(4.76)
Diluted (loss) earnings per share:				
Continuing operations	$	(5.16)	$	(5.16)
Discontinued operations		(0.03)		0.40
Diluted loss per share	$	(5.19)	$	(4.76)
Dividends per common share	$	0.38	$	1.14
Weighted-average common shares outstanding:				
Basic		94.8		102.0
Diluted		94.8		102.0

As I mentioned earlier, the only reason why they are losing money is because sales are going down.

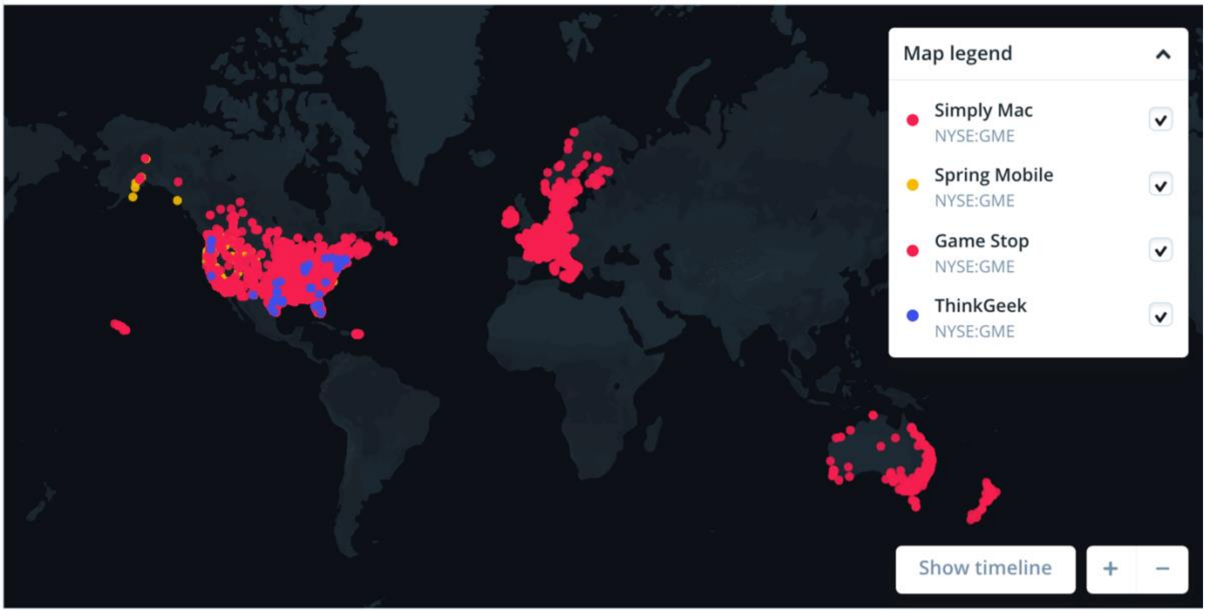
If now we compare margins, QoQ and YoY, there is something interesting to note

Percentage of Net Sales:		
Net sales	100.0 %	100.0 %
Cost of sales	69.3	71.2
Gross profit	30.7	28.8
Selling, general and administrative expenses	31.4	23.9
Depreciation and amortization	1.6	1.3
Goodwill impairments	—	28.8
Asset impairments	0.8	1.6
Operating loss	(3.1)	(26.8)
Interest expense, net	0.5	0.6
Loss from continuing operations before income taxes	(3.6)	(27.4)
Income tax expense (benefit)	2.2	(1.2)
Net loss from continuing operations	(5.8)	(26.2)
(Loss) income from discontinued operations, net of tax	—	1.0
Net loss	(5.8) %	(25.2) %

Percentage of Net Sales:

Net sales	100.0 %	100.0 %
Cost of sales	69.3	70.1
Gross profit	30.7	29.9
Selling, general and administrative expenses	31.4	26.1
Depreciation and amortization	1.6	1.5
Goodwill impairments	8.5	10.7
Asset impairments	0.3	0.6
Operating loss	(11.1)	(9.0)
Interest expense, net	0.5	0.8
Loss from continuing operations before income taxes	(11.6)	(9.8)
Income tax (benefit) expense	(0.2)	0.3
Net loss from continuing operations	(11.4)	(10.1)
(Loss) income from discontinued operations, net of tax	(0.1)	0.8
Net loss	(11.5) %	(9.3) %

They are losing money because of "Selling, general and administrative expenses". Their gross profit margin is about the same. It is these selling expenses that it is eating cash from the business. Most of these costs come from running these 5000+ stores which are not even selling that many products. The best thing to do is to reduce the number of stores.



According to this analysis, 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. In other words, gamers who want to head to a real-world GameStop have options within a ten- to twenty-minute drive.

It doesn't make sense to keep so many stores as more and more people are shopping online. If gamers who like to buy in a physical location really want it, they will just need to drive for a few extra minutes. That's not really a big deal.

GameStop doesn't own all these stores, last year, they spent nearly $360 million in leases alone.

Rent expense under operating leases was as follows (in millions):

	Fiscal Year		
	2018	2017	2016
Minimum	$ 350.5	$ 357.0	$ 355.9
Percentage rentals	7.1	8.3	6.5
Total rent expense	$ 357.6	$ 365.3	$ 362.4

By closing more stores, expenses on labor will also go down. I'm not here to tell GameStop how to do its business. I'm just accessing the situation. Let's get back to the analysis.

	November 2, 2019	November 3, 2018
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 290.3	$ 448.6
Receivables, net	145.7	152.3
Merchandise inventories, net	1,286.7	1,881.5
Prepaid expenses and other current assets	127.6	149.0
Assets held for sale	12.8	631.6
Total current assets	1,863.1	3,263.0
Property and equipment, net	287.1	323.9
Operating lease right-of-use assets	758.1	—
Deferred income taxes	157.8	189.0
Goodwill	—	777.0
Other noncurrent assets	79.5	103.8
Total assets	$ 3,145.6	$ 4,656.7

On the asset side of the balance sheet, we can see a decrease in cash and cash equivalents. That's because they bought back a large number of shares and repaid the debt. As for the reduction in inventories, that's concerning. However, it can also mean that they are just preparing themselves for the next console cycle by getting rid of the current inventories. We will check this hypothesis a little later.

LIABILITIES AND STOCKHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$ 709.9	$ 1,452.8
Accrued and other current liabilities	625.1	700.8
Current portion of operating lease liabilities	238.5	—
Current portion of debt, net	—	348.8
Liabilities held for sale	—	54.3
Total current liabilities	1,573.5	2,556.7
Deferred income taxes	0.1	0.1
Long-term debt, net	419.4	471.2
Operating lease liabilities	516.5	—
Other long-term liabilities	19.0	63.6
Total liabilities	2,528.5	3,091.6
Total stockholders' equity	617.1	1,565.1
Total liabilities and stockholders' equity	$ 3,145.6	$ 4,656.7

On the liabilities side, there's nothing interesting to note. The book value of the company fell by 23%. They bought back over 30% of the company. It was to be expected. Book value per share fell from $7.91 to $7.52, that is, a fall of 4.9%.

Let's now look at free cash flows

	13 Weeks Ended November 2, 2019	13 Weeks Ended November 3, 2018	39 Weeks Ended November 2, 2019	39 Weeks Ended November 3, 2018
Adjusted Operating (Loss) Earnings				
Operating loss	$ (45.6)	$ (517.9)	$ (474.8)	$ (469.9)
Transformation costs	10.4	—	27.1	—
Business divestitures	1.3	—	1.3	—
Goodwill impairments	—	557.3	363.9	557.3
Property, equipment & other asset impairments	11.3	—	11.3	—
Intangible impairments	—	30.2	—	30.2
Severance and other	4.0	—	24.3	11.2
Adjusted operating (loss) earnings	$ (18.6)	$ 69.6	$ (46.9)	$ 128.8

Adjusted Net (Loss) Income				
Net loss	$ (83.4)	$ (488.6)	$ (491.9)	$ (485.3)
(Loss) income from discontinued operations	(0.2)	18.3	(2.6)	41.0
Net loss from continuing operations	(83.2)	(506.9)	(489.3)	(526.3)
Transformation costs	10.4	—	27.1	—
Business divestitures	1.3	—	1.3	—
Goodwill impairments	—	557.3	363.9	557.3
Property, equipment & other asset impairments	11.3	—	11.3	—
Intangible Impairments	—	30.2	—	30.2
Severance and other	4.0	—	24.3	11.2
Tax adjustments	16.0	(30.6)	(3.3)	(32.1)
France tax audit/tax legislation	—	—	—	29.6
Adjusted net (loss) income	$ (40.2)	$ 50.0	$ (64.7)	$ 69.9

We will calculate the owner's earnings of the company:

	3Q 2018	9 months 2018	3Q 2019	9 months 2019
net income	$ (488.60)	$ (485.00)	$ (83.40)	$ (491.00)
depreciation and amortization	$ 25.00	$ 80.50	$ 23.60	$ 69.30
other non cash expenses	$ 587.50	$ 587.00	$ 11.30	$ 375.00
capital expenditure	$ 25.00	$ 100.00	$ 20.00	$ 80.00
Owner's earnings	$ 98.90	$ 82.50	$ (68.50)	$ (126.70)
Shares	102.20	$ 102.00	82.10	82.10
Owner's earnings/share	$ 0.97	$ 0.81	$ (0.83)	$ (1.54)

It doesn't look so good. Even if they repurchased their shares, their owner's earnings/share is going down and is negative. I mentioned that this will happen in my initial analysis. Only next year, we shall expect improvements as the new console come out.

I expected the owner's earnings to be around $200 million after the new consoles come out. We will see a little below if this forecast still holds. Let's first see what the management had to say during the conference call.

> It's important to keep in mind that this is not uniquely a GameStop issue. This is a console issue and consoles are the trigger point for our industry. With Generation nine consoles on the horizon set to bring excitement and significant innovation to the video game space, those anticipated releases in late 2020 are putting pressure on the current generation of consoles and related games, as consumers wait for new technology and publishers address their software delivery plans.

The CEO, George Sherman, blames the end of this console cycle for the low sales.

> Looking ahead, we believe this trend will likely carry through our next several quarters until the launch of the next-generation consoles. At this stage, we've entered the commoditization phase of the console cycle, where promotional pricing is driving sales. And if you're out shopping or doing store checks over Black Friday or Cyber Monday you likely saw a clear example of that discount stands.

And he adds that the trend will continue throughout the next quarters. They are selling the current consoles at promotional prices.

> First, we have shared with you our commitment to evaluate every aspect of our business and take decisive actions to address underperforming areas of our business. In that light, we've begun the process to wind down our operations in the Nordic region of Europe, including operations in Denmark, Finland, Norway and Sweden. While this will take several months to complete, we believe this effort will yield roughly $15 million in EBITDA run rate improvement.

They are closing more stores. Good!

> Despite the overall sales results, we do have several things within our business that are doing well. Even within new hardware, where we have recent innovations such as the Nintendo Switch and switch light, we are seeing strong double-digit sales growth, where consumer interest continuing to increase across that platform. You can see the strength of the switch platform reflected in our recently implemented merchandising floor set across the chain and in particular, across our Black Friday and Cyber Monday offerings, as we highlighted the product and gave a high-profile placement across our omni-channel platform.

Sales growth of Nintendo Switch are double digit. That’s good news as we can expect the same from new generation consoles from Microsoft and Sony, which are more popular than the Nintendo ones.

As we continue our evaluation of underperforming aspects of our business, we are on track to have between 230 and 250 less stores on a global basis, net of new openings by the end of fiscal 2019. The closure rate of underperforming stores is very consistent with the last several years and supports our continued efforts to dedensify our fleet to optimize profit production in select markets and trade areas. Approximately 140 of these underperforming stores closed already earlier in the year.

The CFO confirms that there will be a further reduction in number of stores.

Given the aggregate impact of the above items and particularly the softer than expected trend in sales, we now expect EPS for the full year after adjusting for onetime items to be in the $0.10 to $0.20 range. Despite the top line declines in the business, our balance sheet remains strong as we anticipate ending the year with total cash and liquidity in excess of $1 billion and we expect to generate between $200 million and $220 million in adjusted free cash flow for fiscal 2019.

That’s quite optimistic. I am not going to listen to these forecasts. They are selling us the stock. If they can do it, it’s good but I’m not relying on that. The $200 million in free cash flow which I mentioned is when the new consoles are launched next year. Before that, there is no need for too much optimism.

Ashley Helgans

Hi, this is Ashley Helgans on for Stephanie Wissink. Thanks for taking our question. The SG&A ratio remains distorted versus sales even with the cost optimization program in place. How should we think about the phasing of savings going forward?

Jim Bell

Yeah, I think -- hi, Ashley this is Jim. I think you can -- as we've talked about the vast majority of the savings you can see it in the third quarter this year versus last year but as it starts to annualize over the course of 2020, you're going to see obviously a better impact on an annualized basis. You're just really seeing a first full quarter of the effect in the third quarter this year.

They say that Selling, generals and Administrative costs are going down with new policies that were recently implemented. I think that this is the priority of the company right now.

> We remain supremely confident in our bounce back in -- on or about November of next year. And I think there'll be a point next year we can almost name the date. I mean, that is going to have a profound impact on our business. We tend to over-index, early cycle, because the disc requires some level of education to the consumer.

Apparently, we should expect the stock to bounce next November. I don't know.

Curtis Nagel

Good evening. Thanks for taking the question. I guess, just the first one focused on the buyback. And I guess just why buy back so much stock when at the moment there's still so much uncertainty around the business and results continue to disappoint? I guess the point that there's a new cycle coming, but it's a year from now and a lot can happen from then to now or not to them? And why is it not in the best interest of the company to preserve cash.

Jim Bell

Yes, Kurt, this is Jim. I think again we constantly evaluate what the optimum utilization of capital is and when we say optimal meaning, optimizing the returns for our shareholders. And that's a balance of maintaining appropriate levels of cash and strength of our balance sheet it involves the management of our debt ratios. It involves ultimately where we think is appropriate in a very metered way today in terms of any potential CapEx in the business but it also involves really being able to return capital to shareholders especially when we see depressed pricing in the marketplace that we've seen in our stock.

Simply speaking, I think it's a view to the fact that we believe our stock is undervalued and we think that's an appropriate and prudent use of capital to return that capital to our shareholders via the buyback. And I'm just going to reemphasize that last point. We buy back stock because we fundamentally believe that our stock is trading at a discount and we're very confident as to where our stock is headed given what's going to happen in 11 months. So we're very, very confident at that bounce back. We're very confident that all the work that's being done right now, around expense structure around margin structure is going to pay off in the form of profit flow-through when sales return and we're certainly going to.

I am satisfied with this answer. The stock price is going down and the company is undervalued, they should buy back shares. However, the number one priority should be to reduce these SG&A expenses. As for preserving cash, it is not necessary with the balance sheet that they have.

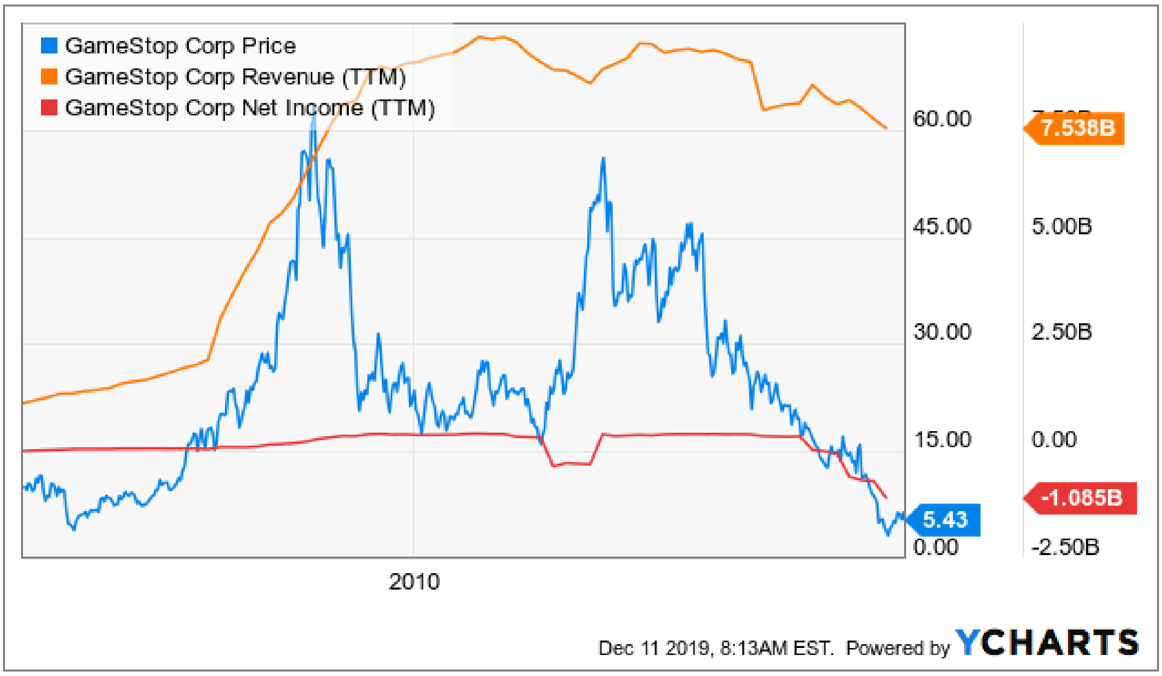
Let's now look at how GameStop did during 2012, a year ahead of the launch of the new consoles

	53 Weeks Ended February 2, 2013	52 Weeks Ended January 28, 2012	52 Weeks Ended January 29, 2011	52 Weeks Ended January 30, 2010	52 Weeks Ended January 31, 2009
	(In millions, except per share data and statistical data)				
Statement of Operations Data:					
Net sales	$ 8,886.7	$9,550.5	$ 9,473.7	$ 9,078.0	$ 8,805.9
Cost of sales	6,235.2	6,871.0	6,936.1	6,643.3	6,535.8
Gross profit	2,651.5	2,679.5	2,537.6	2,434.7	2,270.1
Selling, general and administrative expenses	1,835.9	1,842.1	1,698.8	1,633.3	1,444.0
Depreciation and amortization	176.5	186.3	174.7	162.6	145.0
Goodwill impairments(1)	627.0	—	—	—	—
Asset impairments and restructuring charges(2)	53.7	81.2	1.5	1.8	1.4
Merger-related expenses(3)	—	—	—	—	4.6
Operating earnings (loss)	(41.6)	569.9	662.6	637.0	675.1
Interest expense (income), net	3.3	19.8	35.2	43.2	38.8
Debt extinguishment expense	—	1.0	6.0	5.3	2.3
Earnings (loss) before income tax expense	(44.9)	549.1	621.4	588.5	634.0
Income tax expense	224.9	210.6	214.6	212.8	235.7
Consolidated net income (loss)	(269.8)	338.5	406.8	375.7	398.3
Net loss attributable to noncontrolling interests	0.1	1.4	1.2	1.6	—
Consolidated net income (loss) attributable to GameStop Corp.	$ (269.7)	$ 339.9	$ 408.0	$ 377.3	$ 398.3

Even then, there was a fall in revenues, SG&A remaining at a high level, fall in stock price leading to goodwill impairments and a year when they lost money on the bottom line.

	52 Weeks Ended January 31, 2015	52 Weeks Ended February 1, 2014	53 Weeks Ended February 2, 2013	52 Weeks Ended January 28, 2012	52 Weeks Ended January 29, 2011
	(In millions, except per share data and statistical data)				
Statement of Operations Data:					
Net sales	$ 9,296.0	$ 9,039.5	$ 8,886.7	$ 9,550.5	$ 9,473.7
Cost of sales	6,520.1	6,378.4	6,235.2	6,871.0	6,936.1
Gross profit	2,775.9	2,661.1	2,651.5	2,679.5	2,537.6
Selling, general and administrative expenses	2,001.0	1,892.4	1,835.9	1,842.1	1,698.8
Depreciation and amortization	154.4	166.5	176.5	186.3	174.7
Goodwill impairments(1)	—	10.2	627.0	—	—
Asset impairments and restructuring charges(2)	2.2	18.5	53.7	81.2	1.5
Operating earnings (loss)	618.3	573.5	(41.6)	569.9	662.6
Interest expense	10.0	4.7	3.3	19.8	35.2
Debt extinguishment expense	—	—	—	1.0	6.0
Earnings (loss) before income tax expense	608.3	568.8	(44.9)	549.1	621.4
Income tax expense	215.2	214.6	224.9	210.6	214.6
Net income (loss)	393.1	354.2	(269.8)	338.5	406.8
Net loss attributable to noncontrolling interests	—	—	0.1	1.4	1.2
Net income (loss) attributable to GameStop Corp.	$ 393.1	$ 354.2	$ (269.7)	$ 339.9	$ 408.0

There was eventually a recovery when the new consoles came out.



Is history going to repeat itself and the company will bounce back? Is this just a cyclical thing and we should not be worried?

It really depends on what the management does.

This company is never going to be able to compete with Walmart of Amazon. What they need to do is maintain their brand and focus on a niche. I believe that the company may be acquired in the future.

Here's what the management should do:
1. Reduce expenses by closing stores and reduce number of employees
2. Repay as much debt as possible
3. Buy back shares and return as much money as possible to shareholders
4. Wait for the next consoles to come out

Apart from that, there is not much that they can do. Only after the business can ensure its survival next year that they should think of changing the business and try to grow.

What about me? Will I sell?

I said that I was investing in GameStop for a 35% gain in a year. The stock gained 40% in a month. Should I have taken my profits. Maybe but I was focusing on the long-term. Since they are repurchasing shares, we can expect even bigger gains next year. The mistake that I made was to buy too much too quick. Now the stock is falling, I should have been buying more but I already reached the limit that I was intending to buy.

Ishfaaq Peerally