BUFFETTS BOOKS
BY THE INVESTOR'S PODCAST

INTRINSIC VALUE ASSESSMENT OF

GAMESTOP CORP. (GME)

APRIL 24, 2018

This article was written in collaboration with Christoph Wolf
from The Investor's Podcast and Christoph Wolf Value Investing

Introduction

GameStop is a global retailer focusing on the whole range of video games, namely selling hardware, new video games, pre-owned games, and digital software downloads. Also, collectibles and technology brands (represented by 1329 AT&T branded wireless retail stores and 48 Simply Mac@ stores) form part of GME's business. At the end of the last quarter, GameStop operated 7,276 stores in the US, Canada, Australia, and Europe. Although the business has been highly profitable throughout the last decade, GME has recently experienced many challenges and headwinds. Revenue is only slightly higher compared to 10 years ago, and the future looks uncertain at best.

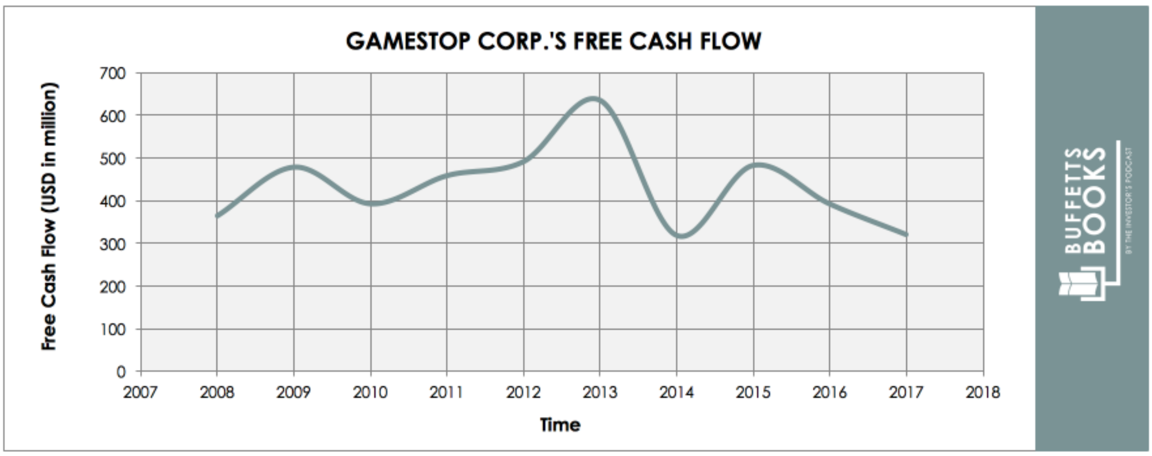
While most brick-and-mortar retailers had a hard time during the last years due to the increasing digital threat by Amazon, GME is even more vulnerable because of its business segment. Video games are more and more downloaded, rendering physical stores selling physical games more and more obsolete. Also, GME's attempts to diversify its business to more sustainable sources have only been partially successful. Recently, the company even had to write down $370 million worth of intangible assets and goodwill of its tech brands – which had been considered the best bet to diversify not long ago.

All of these headwinds have resulted in comparisons to Blockbuster, the home movie and video game rental service that filed for bankruptcy in 2010. GME's stock has been crushed brutally, plummeting from a value of $56 in 2013 to $13 today. Considering that GME's dividend yield seems sustainable and is above 11%, is GME an amazing bargain or will GME's shareholders get burned just as the previous owners of Blockbuster?

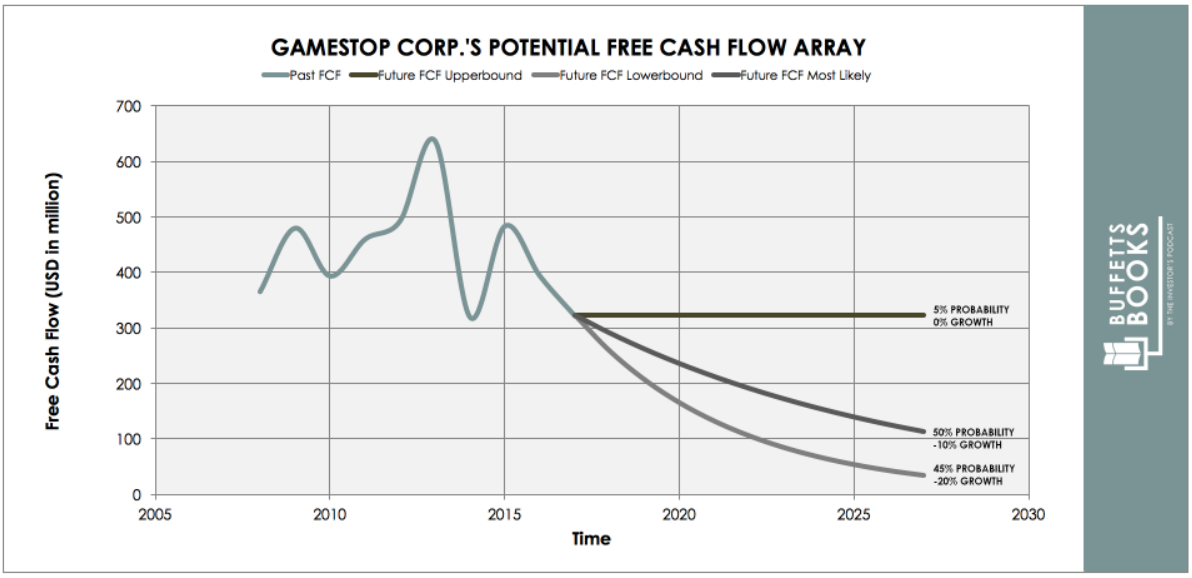
GameStop®

The Intrinsic Value of GameStop Corp.

To determine the value of GME, let's start by looking at the company's history of free cash flow. The free cash flow is important because it represents the company's ability to retain earnings and grow the business. Most importantly, it demonstrates a return on the principal that might be invested into the ownership of equity of the business. Below is a chart of GME's free cash flow over the past ten years.



As one can see, the results have been recently volatile and rather disappointing. This is due to stagnating sales and pressure on margins, which were caused by multiple factors. Firstly, there is immense competition in the retail sector right now – caused by increased digital competition from Amazon and others. GME's business of video games is specifically vulnerable to digital competition, threatening large parts of its business model. The higher gross margins have been pressured by AT&T changing the vendor's commission, which has significantly lowered the gross margins for the business unit "technology brands" which was expected to drive growth. Given all these headwinds, we will use an extremely conservative estimation of its future cash flows.



Each line in the above graph represents a certain probability for occurring. We assume a 5% chance for the upper growth rate of 0% per year, a 50% chance for -7% and a 45% chance for the worst-case scenario of -20% annual growth. Assuming these growth rates and probabilities are accurate, GME can be expected to give a 10.4% annual return at the current price of $13. This stock is truly valued as if the company will follow the fate of Blockbuster and soon cease to exist.

Now, let's discuss how and why those free cash flows could be achieved.

The Competitive Advantage of Fossil Group, Inc.

GME possesses several advantages:

- **Still competitive versus downloads**. The download of a video game can still take up to 12 hours. While this time will surely go down massively in the future, GME's physical software sales are currently remaining relevant. This business segment will continue to decline and might eventually die, but this process could be slower than many anticipate. This gives GME more time to diversify into their two growth business units "Technology Brands" and "Collectibles."
- **Strong free cash flow and immense dividend.** Despite the contraction, GME still has solid FCF and currently holds a dividend yield of more than 11%, which is comfortably covered by earnings with a payout ratio of 44% for the last financial year.
- **Diversified business**. Yes, several business segments of GME are massively threatened. But others like collectibles or hardware are more sustainable. GME is also present in the business of digital downloads of games and other related content. Finally, virtual reality might pose a huge new market ready to conquer by GME.

Risk Factors
The risks for GME are impossible to overlook. Large parts of its business model are under threat, and the company must urgently find a new niche. Here is a list of the most important headwinds:

- **Competition from video downloads.** Even their management expects to render large parts of GME's business model obsolete.
- **Sales growth in the wrong segments.** While GME's has grown its sales in 2018, this growth was largely in the lowest margin areas like hardware.
- **The "Technology Brand" initiative is stuck.** Hailed initially as a great way to diversify, it has so far disappointed and even $370 million impairment charges had to be taken during the latest quarter. GME's agreement with AT&T was recently changed by the latter company, leading to lower returns for GME. Also, the late arrival of the new iPhones was a drag on GME's business unit.
- **While GME's financials look solid, its balance sheet consists mostly of intangibles.** Should the company every declare bankruptcy, there is no tangible book value left for the owners and creditors.
- **According to the latest guidance, management expects sales to decline by 2-4% during the current financial year.** Cautious investors should also expect margins to follow.

Opportunity Costs
When looking at various investing opportunities on the market today, let's compare the expected return of GME to other ideas. First, one could invest in the ten-year treasury bond which is producing a 2.8% return. Considering the bond is completely impacted by inflation, the real return of this option is likely below 1%. Currently, the S&P 500 Shiller P/E ratio is 31.7. As a result, the U.S. Stock market is priced at a 3.2% yield. If one were to invest in the S&P500, they might purchase a low-cost ETF to take advantage of this return.

Macro Factors
The retail sector currently experiences a major disruption– not only because of the digital threat by Amazon, but also because of demographic factors and changed shopping behavior. Since GME's business consists mostly of video games, the company is under additional attack due to increased download speeds and a move away from physical stores and games. While GME's business model will have to change drastically, this also offers new opportunities for the company, namely through games for the vast smartphone market, technology brands, or virtual reality.

INTRINSIC VALUE ASSESSMENT OF
GAMESTOP CORP. (GME)

Summary

GME is a very intriguing company. Not because of the fundamentals or price momentum is great, but due to the low valuation. That being said, there is an immense amount of uncertainty about the sustainability of new and current business units, which might in the worst-case lead to a complete breakdown of its business. The retail sector, but even more so the digital retail sector, is currently undergoing one of the largest disruptions in history. GME has felt this too, and margins are declining.

The projected annual return of 10.4% seems very rewarding even with our conservative estimates. Keep in mind that you might be catching a falling knife, and often there are very good reasons why stocks and GME is surely close to that in the eyes of investors, are priced for bankruptcy.

Make sure to check out the Mastermind discussion GME in the Q2 2017 Mastermind Meeting here.

Disclaimer: The author of this article is long GME at the time of writing.