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GameStop Long Pitch
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Executive Summary:
GameStop (GME) has many market misconceptions that make it attractive to a value investor. Plenty of investors still see GameStop as the "Blockbuster" of video games, destined to fail in the coming years due to an unsustainable business model. In fact, GameStop recently became the #9 most shorted S&P 500 stock.

In this article I will outline GameStop's very diverse business models (yes models) and explain why I see GameStop gaining on or remaining relatively on par with the market in the coming years. I see GameStop as a long play due to the aforementioned short positions, misconceptions, and faith in the acquisitions of the strong management team.

Moreover, as of this writing, the stock has pulled back over 18.6% from its 52-week high, giving potential investors an enticing entry point that could lead to above-average future returns.

Business/Pitch Overview:

GameStop is much more than a simple retail store that makes money selling used video games. The company's management realized years ago what the market eventually realized about Blockbuster - the "resale" or "rental" business simply won't cut it. In order to keep the business alive, the company has expanded into several different product lines. As such, GameStop is very multi-faceted, containing several different business models, ranging from magazine subscriptions to online gaming websites to retail stores linked with Apple and AT&T. I will detail each one, describing why they are important to GameStop.

Magazine Subscriptions and Loyalty Program:

GameStop owns and distributes *GameInformer*, the largest (by circulation last year) video game magazine in the world, and the third largest magazine in the United States, with almost 8 million subscribers. You read that correctly, the **third largest**magazine in the United States last year, ahead of National Geographic, Reader's Digest, People, Time, Sports Illustrated, O, Redbook... You get the point; this magazine has a huge following. The magazine features exclusive previews of games, interviews with studios and producers, and many other features that gamers clearly find appealing.

In addition to selling these subscriptions, GameStop has ingeniously tied the magazine to its loyalty program, PowerUp Rewards. Every subscription to the magazine is paired with a free PowerUp Rewards account. The PowerUp card introduces a point system for rewards, incentivizing gamers to be loyal to the store. Every dollar spent at the store accumulates points, which members can use to access special content and earn chances at epic sweepstakes.

In 2010, GameStop took PowerUp Rewards further, adding a freemium model to monetize its customers. Every magazine subscription is now combined with a one-year "Pro" membership, which non-GameInformer subscribers can also purchase separately. "Pro" unlocks exclusive data from GameInformer online, lowers prices for everything bought in store, raises trade-in values for items brought to sell, and conversely gives a one year subscription to GameInformer when bought.

These products bring GameStop customer loyalty, increased revenues, and establish high switching costs for its customers.

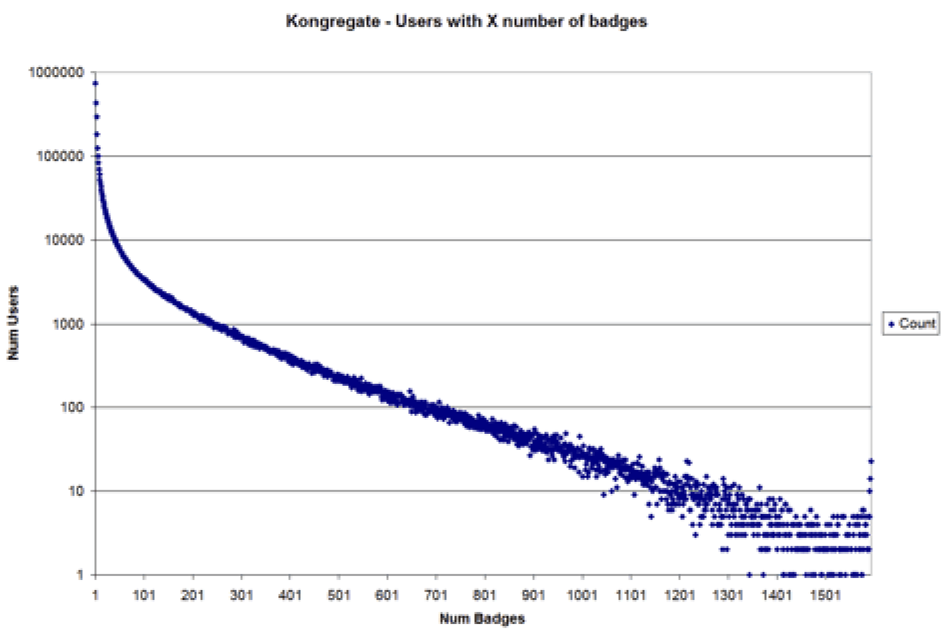
Kongregate's Online Gaming Community:

In 2010, the firm also bought Kongregate, an online gaming community. I say community because it really is one; developers upload games, users play and rate the games, and everyone earns "badges" and points (yes more points, GameStop knows its target market well).

Instead of gushing about the features of the site, I'll get down to what matters most: how the site generates revenue for GameStop. Every Kongregate account is linked to a PowerUp Rewards account. Signing up gives the gamer a PowerUp account, and playing games and earning "badges" earns PowerUp points. The account holder can then use these for items at GameStop stores, increasing in-store visits and purchases.

The chart below shows the number of people having earned differing numbers of "badges" by playing games on Kongregate. As you can see, most gamers have earned at least a few "badges," and some gamers are very, very loyal to the site, considering it takes a while to play different games and earn them.

(Chart showing Badges earned as of 2012 - thanks to Zalbee for data)



In addition, developers have extensive motivation to make great games and get them played; the site offers devs up to 50% of advertising revenue generated from games. This contributes to Kongregate's great game selection, which brings over 15 million monthly unique visitors to the site who spend more than 28 million hours monthly playing games. Kongregate, as the article details, also just launched its mobile platform, offering a new market for the future.

Another method of monetization the site employs is the buying of "Kreds," online currency for purchasing in-game upgrades. Developers have great incentive to encourage Kreds and implement opportunities to use them in-game, as developers receive 70% of Kred value used on a game they upload. Yet another revenue stream for GameStop.

Acquisition X2 - Impulse and Spawn

As I said before, GameStop long ago realized its brick-and-mortar stores would not sustain business into the future. In addition to selling GameInformer and acquiring Kongregate in recent years, GameStop has paid down most of its debt in order to make other acquisitions, the most important of which are Impulse and Spawn Labs.

On March 31, 2011, GameStop officially acquired Spawn Labs, a game-streaming service, as well as Impulse - a digital distribution platform. These acquisitions gave GameStop the opportunity to cash in on markets it had previously untapped.

Spawn Labs has technology that allows for the streaming of games to any internet-enabled device, while Impulse is a diverse platform that establishes the ability to buy, download, and update software, as well as enabling users to chat, blog, and win achievements. Using these technologies, GameStop created "Impulse Driven," a website that allows PC gamers across the world to conveniently purchase games, downloadable content, and other items, all while earning achievements as well as (you guessed it) PowerUp Rewards points.

As the company had not previously been able to engage gamers more interested in streaming and direct downloading, these acquisitions allow for GameStop to capture this important market in the coming years as game sales (predictively) decline.

(Impulse Driven - GameStop's Entry Into Digital Gaming)

More Diversification of the Business Strategy:

GameStop has implemented yet *more* business operations in the last 5 years, absorbing BuyMyTronics, and most recently, Simply Mac and Spring Mobile. BuyMyTronics was a Denver-based company that focuses on refurbishing and reselling electronics, which closely mirrors GameStop's model with game equipment. Through BuyMyTronics, GameStop is marketing to its current customer base with a different product, while leveraging its current strengths as a resale store. Users send in their out-of-date or non-working electronics, and GameStop sends customers cash in return. The company then repairs these products then sells them to consumers at a mark-up. Both parties win in this situation, which gives the business model strength into the future.

In August of this year, GameStop acquired Simply Mac, another retail store that leverages GameStop's expertise in the buy-sell-trade sector. This store operates over 20 locations in 9 states, and is planning on opening several more locations in the coming months. Simply Mac not only provides servicing for Apple products, it also operates as a resale store where users can sell old Apple equipment, similar to BuyMyTronics. As such, GameStop has deftly and skillfully aligned itself with Apple; as Apple thrives, so will revenues for GameStop.

Spring Mobile is GameStop's latest acquisition, occurring on November 23. A wireless retailer for AT&T that operates over 150 stores in 14 states, Spring sells mobile solutions and data plans to AT&T customers as one of its largest authorized dealers. This acquisition creates synergies between the two business models as it focuses on real estate as well as the buy-sell-trade model retail store. Through Spring Mobile, GameStop also gains penetration into the wireless market, tying itself to AT&T and its continued success, following in the same mold as Simply Mac.

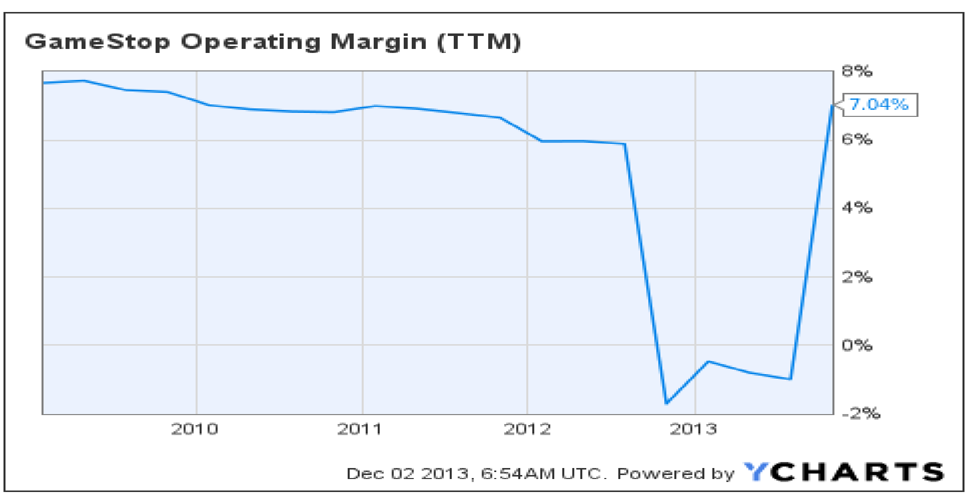
All of these acquisitions give GameStop a way to maintain its leases and physical building space should the game market transition over time to be completely online.**The firm can simply begin selling iPads, iPhones, AT&T wireless products, and refurbished electronics out of its current retail space instead of video games.**

Paul Raines and GameStop Executives:

J. Paul Raines, GameStop's CEO, clearly values a sound business strategy that involves diversification and hedging against losses. He focuses on hiring the brightest minds to help him complete this strategy and position GameStop competitively into the future. In a recent *Fortune* article, he said he looks for people with "a passion for innovation and driving a high rate of change;" in the Spring Mobile acquisition, he revealed a focus on "adding significant executive talent... to the GameStop team." The CEO has clearly had success in executing this strategy, as evidenced by the many acquisitions above.

10-Q Differences - A Different Story

At this point in the article, many investors will be thinking, "If this stock is so great, why did it have negative operating margins for a large part of the last year?"



data by YCharts

While GameStop's earnings went down earlier this year, several positive factors present themselves in the firm's 10-Q. In management's discussion of the state of operations, the company discloses that it has "plans

> to continue to invest in these types of processes and channels to grow our digital sales base and enhance our market leadership position in the electronic game industry and in the digital aggregation and distribution category. In addition, we intend to continue to invest in customer loyalty programs designed to attract and retain customers. [As of 2011,] we currently sell tablets and accessories in all of our stores in the United States and in a majority of stores in our international markets. We also sell and accept trades of pre-owned mobile devices in our stores."

This continued plan of investment in business models that will sustain the company into the future should give investors a positive outlook.

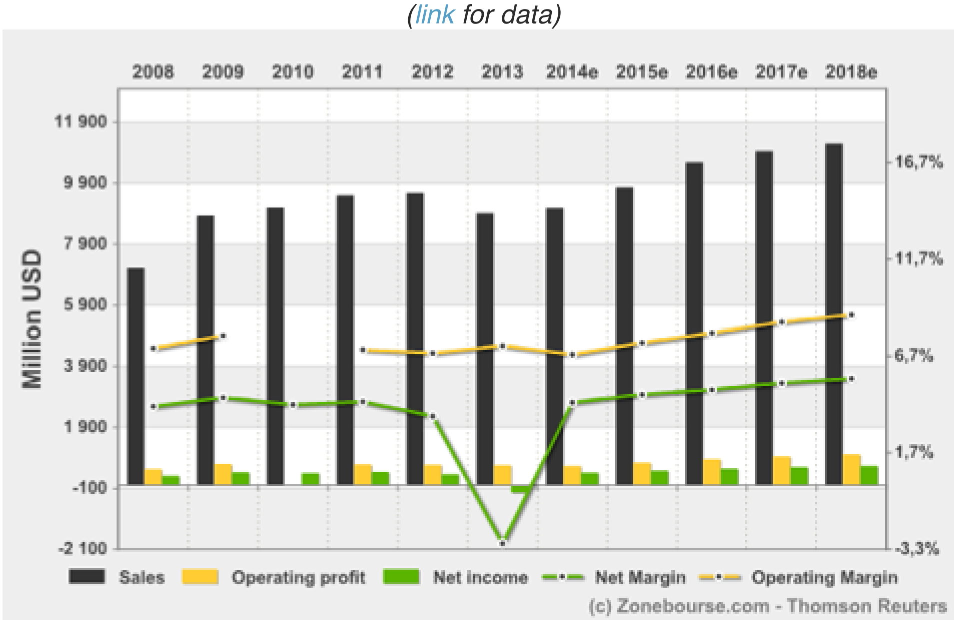
In addition, in those same financial statements, if one looks at the balance sheet, one big line item sticks out from last year to this year: Goodwill. Because of the recent decline in price and operating margin, the firm decreased its goodwill by $616.7 million dollars, which contributed to the "down year" for GME.

One last item that could have had an impact on GME's negative profit margins is that Sony and Microsoft just released their new consoles.

The PlayStation 4 and Xbox One, made by Sony and Microsoft respectively, were released in the last month. These are two of the primary consoles in the gaming market, and the last time two major consoles were released at the same time was 8 years ago. As such, gamers have been holding off on console and game purchases in order to obtain the newest equipment when it comes out. This is a logical explanation as to why GameStop's operating profits significantly declined, as gamers were hesitant to buy new items months before they would be outpaced by new technology.

As the profit chart below shows, this dip is projected as temporary, and can be explained by these extraneous items.

(link for data)



Q4 Low Projections Include New Console Sales:

In Q3, GameStop earnings beat estimates, earning 58 cents per share compared to analyst estimates of 56 cents. In addition, revenue was $2.11 billion, compared to $1.98 billion estimates. Comparable same-store sales went up 20.5%, crushing estimates of 11-15%. The stock is down almost 10.5% since the earnings announcement.

I'll explain. This decline is due in large part to GameStop's low guidance for the fourth quarter. Though the company actually raised its full-year profit guidance, it issued Q4 guidance from $1.97 to $2.14 per share, below average analyst estimates of $2.15.

This large and lower range can be interpreted two ways. One could argue that the company doesn't have faith in its Q4, but I don't see this as entirely true. I believe that the company simply wished to be conservative with its estimates. The company doesn't know how new console releases will shape up, and could be lowering its earnings estimate based on the poor console sales earlier in the year.

Channel checks over the coming months will provide more detail as to how these console sales are coming, but early data (for example, here and here) are **very** encouraging. Even through this data, some users, such as Time's video game correspondent Matt Peckham, are putting off buying the new consoles until next year when games that can fully utilize the consoles' power become more readily available. This bodes well for GameStop's sales over the next couple years.

Stock Repurchase and Dividend:

GameStop's executives further expressed confidence in the stock by announcing a new $500 million stock repurchase in the latest earnings report, decreasing float and increasing the coming EPS for Q4 and beyond.

GameStop's dividend currently sits at around 2.34%, which is not monstrous, but still bears mentioning. As long as GameStop is sitting on cash of $649.1 million, it will be searching for more acquisitions and takeover targets. If it finds none, this dividend could increase substantially.

Conclusion:

I don't think that the market has priced in many of the items covered in this article, while simultaneously pricing in GameStop's low Q4 projections. As stated earlier, many still fear this stock because they believe it to be "The next Blockbuster." I believe this is incorrect, and that MII could profit greatly by investing in this stock at its current low in share price.

***Variant View/Risks I'm Wrong**:*

A friend of mine is pitching this exact same company as a short in his equity analysis class due to the end of console cycles and competition for digital gaming. There is definitely merit to his argument, and MII should monitor the downside to GME in the coming years.

In addition, game publishers have a reason to try and cut out the middleman in this market (GameStop). Many were afraid that the new consoles would prevent the resale of used games, but the community went into uproar when this was rumored. It's in the end-customers' best interest to have these middlemen who can give them a return on their game (even if it's small).

However, if Amazon expands its market share and continues to try and cut out retailers in new and exciting ways, GameStop's retail business could take a hit, but I believe GameStop has enough diversity and the management team to not only avoid this, but flourish through it as well.