

Game Digital

The (BE)long game

Interim results and
collaboration agreement

Retail

A year ago we titled our initiation note 'The long game'. But growth is now more closely tied to the transformative expansion of BELONG, as well as retail formats under the recent collaboration agreement with Sports Direct. These plans represent a direct path to Game Digital's future identity as a service-based business providing gaming experiences.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV/EBITDA (x)	Yield (%)
7/16	821.9	26.4	14.8	10.7	3.4	2.3	0.2	13.7
7/17	782.9	8.0	(4.3)	(3.7)	1.0	N/A	N/A	4.0
7/18e	821.0	10.8	(1.4)	(0.6)	0.0	N/A	N/A	N/A
7/19e	840.8	15.1	0.8	0.4	0.0	66.7	N/A	N/A

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

A transformative moment

Having signed the collaboration agreement with Sports Direct (SD) in February, Game Digital (GMD) is now accelerating its key strategy of widening its reach into experiential areas and engaging with customers more fully. It is planning the roll-out of its BELONG gaming arena concept, where customers experience the latest hardware and game releases, as well as relevant retail operations. It is According to its plans, GMD should be able to roll out 4,000 playing stations in 111 units in the three years to FY21, and 5,000 stations in c 135 units by FY22. That should result in steady state EBITDA of £20m by FY22 at a total capital cost of c £45m.

Satisfactory interims in a strong market

Interim results to January were a reasonable result in a market that, while positive, has some undesirable features. With growth dominated by hardware – which creates the conditions for higher margin content sales thereafter – revenues were biased to low-margin product and GMD has responded with active cost actions.

BELONG supports forecast growth

We adjust our forecast to recognise the new positioning of the BELONG roll-out programme. Our FY18 EBITDA forecast reduces by 11.5% to £10.8m reflecting the new focus on larger sites. From FY19 we expect the momentum of the BELONG opening programme to support EBITDA growth, although our FY20 forecast decreases overall on the slower market forecasts.

Valuation: Blended valuation of 74p

The market is valuing GMD at less than net cash of 48p. We approach valuation on three metrics: peer comparison, DCF and sum-of-the-parts. On a peer basis, which is quite inexact, we would value the shares at 88p. DCF valuation is helpful in valuing the medium-term strategy and gives 71p. On a sum-of-the-parts basis, separating out the growth elements from others, we reach 62p. Averaging all three metrics, we define a blended valuation of 74p (previously 93p). Looking only at GMD's share of the BELONG income stream, its capital cost and adjusted year-end cash, we would value this at £98m, or 53p per share.

27 March 2018

Price 25.0p
Market cap £43m

Net cash (£m) at end January 2018	82.2
Shares in issue	172.9m
Free float	31%
Code	GMD
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(16.0)	(57.5)	(40.7)
Rel (local)	(12.4)	(53.7)	(38.1)
52-week high/low		61.5p	19.2p

Business description

Game Digital is the leading omni-channel specialist retailer of video games in the UK and Spain, with 299 stores in the UK, 267 stores in Spain and over 30% market share.

Next events

July 2018	Trading update
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Collaboration agreement: Power to experiential model

In February 2018 GMD signed a collaboration agreement with SD to roll out both BELONG gaming arenas and/or GAME retail units in standalone and SD stores. SD paid £3.2m for 50% of the existing BELONG business, comprising 19 units within GMD stores.

The agreement and what it says

The agreement states that GMD and SD will cooperate to develop BELONG gaming arenas and GAME retail operations in the following formats:

- Standalone BELONG arenas
- BELONG arenas in or next to GAME retail stores
- BELONG arenas in SD retail stores
- GAME retail stores within SD retail stores
- BELONG arenas with GAME retail stores, within SD retail stores

Each project will be jointly agreed before being committed to. Revenues and operating costs from the applicable operations (including a management fee to GMD) will be split equally between the parties. Where BELONG and GAME retail units are established within SD retail stores, the operating team will be controlled entirely by GMD. Rent will be negotiated as normal for a concession.

Fit-out costs will be borne by GMD, financed by a £35m long-term unsecured capex loan facility extended by SD, at 2.5% over base and with drawdowns repayable over five years following the second anniversary of each opening. SD is also providing a £20m one-year extendable working capital facility at the same rate.

The agreement is formally a profit sharing agreement and is not a joint venture agreement.

Acceleration of a key strategy

BELONG arenas, where customers experience the latest hardware and game releases, are key to GMD's strategy of widening its reach into experiential areas and engaging with customers more fully. The roll-out to date has demonstrated average payback of 16 months, but also that optimum scale is formats above 24 playing positions. Management now plans a roll-out of up to 5,000 BELONG playing stations in the UK. The project is planned to be introduced to Spain during calendar 2018.

Given the number of lease events (272 over the next two years), GMD has significant flexibility to move into larger sites. SD contributes its retail presence and fast-developing estate with increasing numbers of larger stores. Management expects JV sites will have 40-60 positions (we model 40 in openings running at 29 pa).

Focus on BELONG arenas

In our view the key points about the BELONG project are:

- It should position BELONG as market leader in local and regional esports
- Since the investment is in shop fit-outs, with significant supplier funding and support, it has relatively low capex with fast payback
- Strategically important for both parties and therefore should receive close management attention

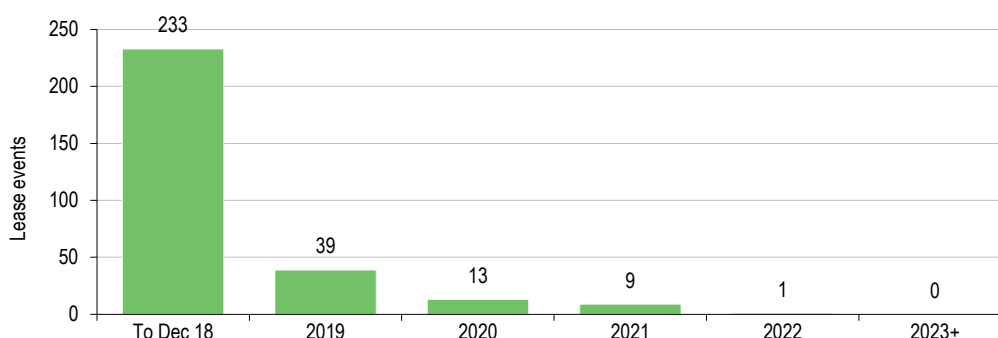
- High margin: it has a 100% margin profile for pay-to-play. Including food and drink, PC hardware, accessories, digital products and VR, gross margin is 45% and after incremental rent, labour, supplier contributions and management fees, GMD's retained share of operating profit is planned at 23% of total revenue
- High occupancy: existing units that conform to the template are achieving 28.5% utilisation
- The concept is powerful in driving new customers into stores: one in four BELONG customers is new to GAME

The company has identified a number of potential BELONG gaming arenas alongside enhanced GAME retail units. We forecast for five of these to open by July 2018.

Real estate opportunity: Optionality for development

The conditions exist for rapid roll-out of the concept, along with GMD's enhanced stores because the company has over 270 lease negotiations over the next two years, largely allowing for the reorganisation of the UK estate:

Exhibit 1: Lease event schedule



Source: GMD

This gives management negotiating leverage with landlords because it increases their options. For example, with a small existing store, the company can negotiate with the landlord to extend the property, give a rent-free period etc. Alternatively, the company could form a standalone BELONG arena in a different property, or rehouse the BELONG in a SD development. Or it could convert the existing GAME store into a BELONG arena, taking an entirely new lease for an enhanced GAME store nearby. In a challenged retail property world, this leverage is powerful.

Extension of retail reach under GMD's control

The creation of concessions in selected SD stores responds to GMD's and SD's common customer base. It leverages SD's UK retail presence of c 500 stores and accords with its property 'elevation' strategy of connecting with the consumer through multi-channel experiences and of developing leading flagship stores. But, GMD will have full control of sites selected, terms and unit management.

Roll-out details: The road to 5,000 stations

GMD has now defined its roll-out plans. While these also include BELONG facilities and Game retail concessions within new SD stores, we focus on standalone BELONG units because these provide a clearer model and are not subject to SD's own estate development considerations. Management expects, over the three years to FY21, to roll out some 4,000 playing stations, although there is potential for 5,000 places. Assuming an average of 40 playing stations per site, this is equivalent to 29 openings a year starting in FY19. Clearly we recognise that there is execution risk associated with a project of such scale and rapidity. However:

- This is not a standing start. GMD has been rolling out and trialling the BELONG concept since July 2016 (building to 19 sites) and as a result has acquired experience of how to roll out the format as well as how to gain best returns from the model. Its operating management has gained experience with player teams ('tribes') which link to the existing national tournament structure.
- The company has good leverage and optionality given that it has over 200 lease events in the next 12 months, a number of alternative format combinations and a real estate partnership with SD.
- The retail estate market is well-known to be soft and an operator rolling out an experience-based concept should be in a strong bargaining position.
- Both parties in the agreement are listed companies with strong lease covenants.

For modelling purposes we assume an average BELONG site operates as follows:

Exhibit 2: BELONG arena model		
Desks per site	40	
Playing hours per desk per week	78	
Possible hours per week	3,120	
Actual hours per week	889	
Utilisation	28.5%	
Rate per hour (£)	4.50	
£000	Total	GMD share
Pay-to-play revenue (£k)	208	
PC, VR & F&B sales	468	
Total revenue	676	676
Share of EBITDA	311	156
% of sales	46.0%	23.0%
Capex	350	350
Payback years		2.3
Source: GMD		

The operating metrics used in the model are based on those actually being achieved in the larger size BELONG units, of over 30 stations that form the template for the roll-out. Notably, while the playing revenue is running at £4.50 per hour, total revenue is over three times that. The balance relates to sales of PCs, VR equipment and food & beverage. There is also marketing support from suppliers whose products feature in the arenas, for example tournament and software launch support.

We illustrate below how we model the roll-out to 5,000 paying stations. Conservatively, we assume no price inflation or improvement in utilisation. On these assumptions, the full roll-out takes until 2022 and results in 136 units on the additional assumption that all the playing stations were created in the standalone format. That assumption is unlikely to be literally true, but the economics of the model are unlikely to be disadvantageous if, alternatively, they are housed in a large format SD or GAME retail unit.

Exhibit 3: BELONG gaming arenas roll-out

	FY18e	FY19e	FY20e	FY21e	FY22	Run rate
Number, beginning of period		24	53	82	111	136
Openings		29	29	29	25	
Number, end of period	24	53	82	111	136	136
Average	19	31	60	89	117	136
Desks, end period	572	1,732	2,892	4,052	5,052	5,052
£m						
Revenue per site		0.68	0.68	0.68	0.68	0.68
Total revenue	12.8	21.1	40.7	60.4	79.3	92.0
Gross margin (%)	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%
Gross profit	5.8	9.5	18.3	27.2	35.7	41.4
Share of site level EBITDA	2.1	4.9	9.4	13.9	18.2	21.2
EBITDA margin (%)	10.0%	23.0%	23.0%	23.0%	23.0%	23.0%
Central team, other	(4.8)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
GMD share of EBITDA	(2.7)	3.9	8.4	12.9	17.2	20.2
Contribution per location	(141)	124	139	144	147	148
Capital investment each (£k)		350	350	350	350	350
Capital investment total (£m)	3.5	10.2	10.2	10.2	8.8	0.0
Total invested*	5.3	15.5	25.6	35.8	44.5	44.5

Source: Edison Investment Research. Note: *Gross, before the £3.2m received from SD.

Our assumptions result in a steady state EBITDA share of £20m to GMD by FY22.

Financials

Interim results

Interim results showed a decline that was essentially cyclical. EBITDA was down 9% year-on-year, mainly as a result of margin declines resulting from mix changes, mitigated in part by operational efficiencies and cost savings.

Exhibit 4: Summary of results

£m	H117	H118	±
Gross transaction value	565.4	586.8	3.8%
Revenue	498.1	517.4	3.9%
Gross profit	127.1	123.1	-3.1%
Operating costs	-103.8	-101.9	-1.8%
EBITDA	23.3	21.2	-9.0%
PBT	16.9	14.2	-16.0%

Source: GMD. Note: EBITDA, PBT are adjusted.

The trading period saw a strong retail market both in the UK, up 14.3%, and Spain, up 13.5%, driven primarily from strong sales of Nintendo Switch and associated software, following the initial supply problems in the second half of 2017. Microsoft's Xbox One X was launched in November 2017, but had more of an impact on the UK market than Spain.

Exhibit 5: Analysis of gross transaction value (GTV)

£m	H117	H118	±
Hardware	117.6	146.7	24.7%
Content	262.1	265.3	1.2%
A&O	90.0	87.3	-3.0%
Preowned	95.7	87.5	-8.6%
Total	565.4	586.8	3.8%

Source: GMD. Note: Adjusted.

GTV was up by 3.8%, a blend of a 0.3% decline in the UK and a 7.5% constant currency increase in Spain (exchange rates had a c 3% positive effect). The UK had an extreme variation in mix, with console sales up 27.3% but mint software down 1.7%. That software decline reflected in part the 3.9% decline in the number of UK stores, but also a shift to online sales of console product (the

offsetting advantage of which is that it releases store space for new activities such as BELONG, PC sales and VR). In Spain, buoyant hardware growth of 16.5% was supported by content sales up 7.4%. On a group basis, hardware was up 24.7% and content up 1.2%.

Within Accessories & Other (A&O), the core category was down 4.7% £78.4m, as a result of console accessories following the hardware growth, while VR sales declined against major launches last year. Events and Esports, still small at £5.4m, were however up 31.5% on acceleration in BELONG and events.

Pre-owned declined 8.6%, reflecting core categories tracking mint software performance in FY17.

Gross profit: Mix effect

Gross profit slipped 150bp overall as a percentage of GTV: representing a 3.1% decline in gross profit.

Exhibit 6: Summary of gross margin (% of GTV)

%	H117	H118	±
Hardware	5.7	7.1	1.4
Content	23.0	21.6	-1.4
A&O	29.9	32.9	3.0
Preowned	34.6	30.5	-4.1
Total	22.5	21.0	-1.5

Source: GMD

This was primarily an effect from the much higher mix of relatively low-margin hardware in the period, although individual categories had small variations in their own margins.

Operating costs: Savings programme mitigates headwinds

Realised savings of £5m in the period mitigated the decline in gross profit. These were spread across property, payroll, procurement and distribution, with a focus on UK retail, where an overall reduction of £4.0m was achieved. However, linked to volume increases, retail costs in Spain increased leaving the net underlying reduction in costs at £1.9m to £101.9m.

Cash flow and balance sheet

The company was very cash generative with operating cash flow of £36.3m compared with EBITDA of £21.2m, helped by working capital improvements of £16.9m of which we expect c £5m to remain in the full year. The most significant cash item was the receipt of £17.1m from the sale of Multiplay in November 2017, following which net cash was up £13.2m year-on-year at £82.2m.

Forecast: Firming up the BELONG project

Our forecast reflects our projections as set out above for the BELONG project, combined with expected changes in the market cycle at the longer end:

Exhibit 7: Changes to forecasts

	GTV (£m)			Revenue (£m)			EBITDA (£m)			PBT (£m)			EPS (p)		
	From	To	+/-	From	To	+/-	From	To	+/-	From	To	+/-	From	To	+/-
7/18	912.5	925.2	1.4%	793.2	821.0	3.5%	12.3	10.8	-11.5%	0.2	-1.4	N/A	0.1	-0.6	N/A
7/19	916.9	958.2	4.5%	796.3	840.8	5.6%	15.0	15.1	0.4%	1.9	0.9	-54.5%	0.9	0.4	-55.1%
7/20	1,058.2	1015.8	-4.0%	920.4	899.0	-2.3%	33.1	25.1	-24.3%	17.7	7.2	-59.5%	7.9	3.2	-59.5%
Absolute change FY18			12.7			27.8			-1.4			-1.6			-0.7
Absolute change FY19			41.3			44.5			0.1			-1.1			-0.5
Absolute change FY20			-42.4			-21.4			-8.0			-10.5			-4.7

Source: Edison Investment Research

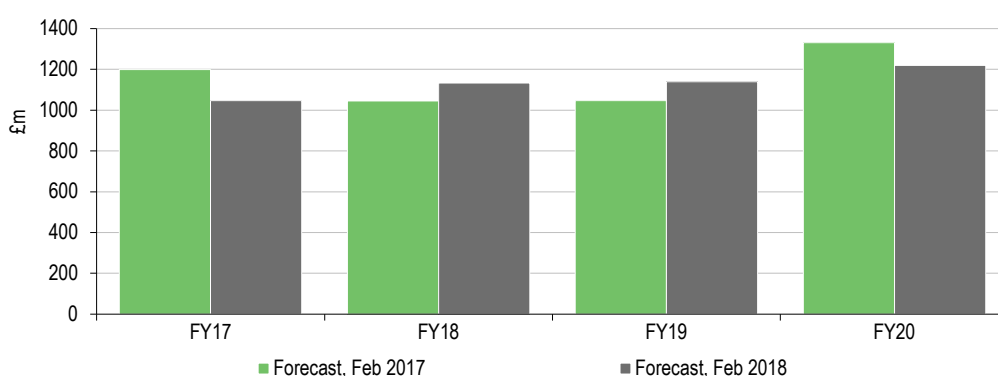
The market in H218 remains strong both in the UK and Spain, although the Nintendo Switch launch has just annualised, and its growth path in FY17-18 will provide a like-for-like challenge ahead. In

addition, although well-established houses have announced Nintendo titles, their timing has not been confirmed, while other game titles have moved from H218 to H119. This has prompted a response from the company, which now has actions in hand to save £6m of costs in H2 in addition to the £5m saved in H1.

Our FY18 EBITDA forecast has reduced mainly as a result of the repositioning of the BELONG roll-out programme. As a result of management's conclusion that only larger formats should be used, combined with the SD negotiations, we now only expect 24 to be open by the end of the financial year compared with 45 in our previous forecast. But from FY19 we expect the momentum of the BELONG opening programme to drive EBITDA ahead based on our roll-out projections.

The overall decrease in our FY20 forecast needs to be seen in the context of an 8% reduction in market forecasts for that year, as a result of revised expectations for the PS5 launch, while still markedly higher than the previous two years.

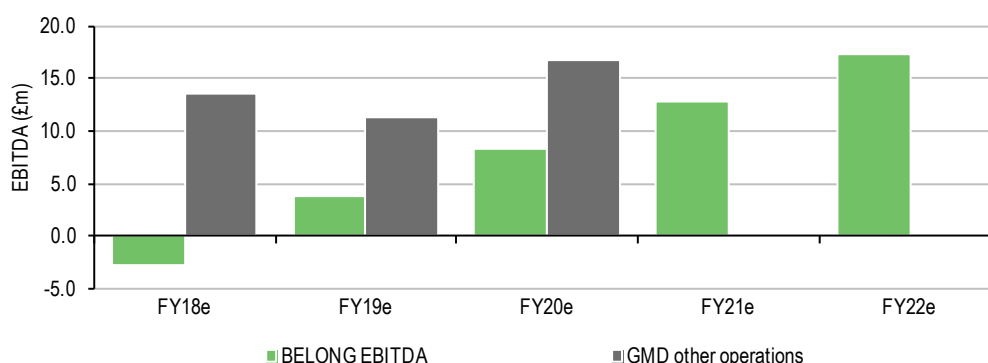
Exhibit 8: Year-on-year change in market forecasts, hardware and content



Source: Market data from GMD (February 2017 forecasts adjusted to July year end by Edison)

Although we have not forecast GMD beyond FY20, our further forecasts for EBITDA of BELONG, against the company forecast to that point should be of interest to investors:

Exhibit 9: Forecast EBITDA of BELONG vs rest of GMD



Source: Edison

This illustrates the consistent growth of the BELONG concept, which should be largely independent of the traditional gaming cycle, which is governed by the timing of hardware model releases.

Valuation

We approach valuation on three metrics: peer comparison, DCF and sum-of-the-parts.

Peer comparison: An approximate science

There is no exact peer, the nearest being US operator Gamestop, which shares a stated change strategy involving a move away from reliance on physical products. It trades on year one and two P/E multiples of 4.7x, and EV/EBITDA of 2.8x which imply a GMD value of 56p. Also appropriate (as they serve special interest groups) are UK small-caps Games Workshop, Goals Soccer Centres, Everyman Media Group and Focusrite. These trade on an average EV/EBITDA multiple of 11.9x in year one and 10.8x in year two. Averaged between the years, that implies a GMD value of 120p. Taking the average of these two values produces a valuation of 88p (unchanged).

DCF valuation: Valuing the medium-term strategy

DCF is an appropriate metric because it does take account of medium-term strategy, albeit this is subject to risk across a number of years. In view of that, we apply a high 15% WACC to the future streams. To represent the cycle, we assume the next three years' revenue growth beyond our 2020 forecast is the same as the average for the previous three before fading to a terminal 2% over the final three years. We assume no change in the 2020 EBITDA margin, and we conservatively reflect maintenance capex at 2% of revenue. On this basis, we value the shares at 71p (previously 72p). That is c 10p sensitive to a 1% change in WACC and c 20p sensitive to a 1% change in the margin assumption.

Sum of the parts: Focus on the growth element

Since GMD is on a path to realise a business independent of the zero-sum-game cycle, our preferred measure is to create a valuation of each element. We define the growth element as A&O, Gametronics, Esports, Events and Digital. Below the forecast gross profit level, we model specific operating costs in esports, events and digital, and BELONG operating costs. We then allocate operating costs pro-rata to revenue, which is slightly unfair to the growth businesses, which therefore pick up a higher share.

Exhibit 10: Forecast EBITDA – growth and core businesses

£m	FY17e	FY18e	FY19e	FY20e
Growth categories	4.7	9.1	14.5	24.0
Other categories	3.3	1.8	0.6	1.1
Total	8.0	10.8	15.1	25.1

Source: Edison Investment Research

For non-growth operations, we reproduce the cycle by averaging the last three years' EBITDA of core operations and, after capex and tax, value it as a perpetuity assuming 2% growth, at 4p per share. In the case of growth businesses, we conservatively fade revenue growth from a 2020 rate of 21% to terminal growth of 2%, producing a DCF valuation of 58p. The sum of the two is 62p.

Averaging all three metrics, we define a blended valuation of 74p (previously 93p).

A further consideration: Future EBITDA

As shown in Exhibit 9 above, the growing operations under the collaboration agreement, as represented by our BELONG projections, is set to dominate the company's earnings. As shown in our projection at Exhibit 3, the roll-out of 5,000 paying stations would suggest steady state EBITDA of £20m by FY22. On the current All-Share General Retailers 12-month forward EV/EBITDA multiple of 6.5x, that would equate to £130m, which discounted at 10% would suggest an EV of £76m. Subtracting the £45m capital cost of the project gives a value of £31m or 18p. Adding the company's net cash of £60m (year-end £43m adjusted for disposal proceeds of £17m), or 35p, results in a total of 53p per share.

Exhibit 11: Financial summary

Accounts: IFRS, Yr end: July, GBP: Millions	2015A	2016A	2017A	2018E	2019E	2020E
Profit and Loss statement						
Total revenues	866.6	821.9	782.9	821.0	840.8	899.0
Cost of sales	(652.9)	(612.7)	(577.8)	(621.8)	(630.7)	(677.6)
Gross profit	213.7	209.2	205.1	199.2	210.1	221.4
Other income/(expense)	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals and adjustments	(12.2)	(12.9)	(5.7)	(2.6)	(9.6)	(9.6)
Depreciation and amortisation	(8.5)	(10.5)	(11.0)	(11.5)	(13.3)	(16.2)
Reported EBIT	26.2	3.0	(8.7)	(3.2)	(7.8)	(0.7)
Finance income/(expense)	(0.4)	(1.1)	(1.3)	(0.8)	(0.9)	(1.7)
Exceptionals and adjustments	(3.7)	(3.8)	3.9	7.0	0.0	0.0
Reported PBT	25.8	1.9	(10.0)	(4.0)	(8.8)	(2.5)
Income tax expense (includes exceptionals)	(4.4)	1.3	(2.1)	0.3	(0.2)	(1.6)
Reported net income	21.4	3.2	(12.1)	(3.7)	(8.9)	(4.0)
Basic average number of shares, m	168.3	168.9	169.7	172.9	172.9	172.9
Basic EPS, p	12.7	1.9	(7.1)	(2.1)	(5.2)	(2.3)
Dividend per share, p	14.7	3.4	1.0	0.0	0.0	4.0
Adjusted EBITDA	46.9	26.4	8.0	10.8	15.1	25.1
Adjusted EBIT	38.4	15.9	(3.0)	(0.6)	1.8	8.9
Adjusted PBT	38.0	14.8	(4.3)	(1.4)	0.8	7.1
Adjusted diluted EPS, p	18.5	10.7	(3.7)	(0.6)	0.4	3.2
Balance sheet						
Property, plant and equipment	19.2	16.8	17.2	18.5	29.7	38.3
Goodwill	0.0	0.0	0.0	0.0	0.0	0.0
Intangible assets	61.0	56.7	47.5	29.3	15.6	1.9
Other non-current assets	0.2	2.2	2.5	2.5	2.5	2.5
Total non-current assets	80.4	75.7	67.2	50.3	47.8	42.7
Cash and equivalents	63.1	48.8	47.2	71.1	67.8	63.9
Inventories	66.8	76.1	81.2	76.2	77.3	83.0
Trade and other receivables	17.8	20.4	23.5	20.6	21.1	22.6
Other current assets	0.9	8.8	1.7	3.6	1.7	1.7
Total current assets	148.6	154.1	153.6	171.5	167.9	171.2
Non-current loans and borrowings	0.1	3.1	2.6	2.6	2.6	2.6
Other non-current liabilities	5.7	4.4	2.8	2.8	2.8	2.8
Total non-current liabilities	5.8	7.5	5.4	5.4	5.4	5.4
Trade and other payables	93.8	90.7	101.6	98.8	100.2	107.7
Current loans and borrowings	0.0	7.2	2.0	7.7	7.7	7.7
Other current liabilities	3.2	1.3	2.6	2.6	2.6	2.6
Total current liabilities	97.0	99.2	106.2	109.1	110.5	118.0
Equity attributable to company	126.2	123.1	109.2	107.3	99.8	90.5
Cashflow statement						
Cash from operations (CFO)	44.1	3.2	9.1	19.5	17.0	26.0
Capex	(11.3)	(13.3)	(11.6)	(17.6)	(24.5)	(24.8)
Acquisitions & disposals net	(12.4)	(1.5)	13.3	17.1	1.9	0.0
Other investing activities	(0.2)	0.0	0.0	0.0	0.0	0.0
Cash used in investing activities (CFIA)	(23.9)	(14.8)	1.7	(0.5)	(22.6)	(24.8)
Net proceeds from issue of shares	0.0	0.0	0.0	0.0	0.0	0.0
Movements in debt	(1.5)	1.5	0.0	0.0	0.0	0.0
Other financing activities	(37.8)	(13.9)	(4.3)	(0.8)	(0.9)	(5.2)
Cash from financing activities (CFF)	(39.3)	(12.4)	(4.3)	(0.8)	(0.9)	(5.2)
Increase/(decrease) in cash and equivalents	(19.1)	(24.0)	6.5	18.2	(6.5)	(4.0)
Currency translation differences and other	(3.1)	1.0	0.6	0.0	0.0	0.0
Cash and equivalents at end of period	63.1	40.1	47.2	65.4	58.9	58.2
Net (debt) cash	63.0	38.5	42.6	60.8	57.5	53.6
Movement in net (debt) cash over period	63.0	(24.5)	4.1	18.2	(3.3)	(4.0)

Source: GMD, Edison Investment Research

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