EDISON

Game Digital

Trading update

Not a game changer

Retail

The reduction of profit expectations resulting from UK supply shortages of Nintendo's Switch console shows, if proof were needed, that Game Digital is still tied into the old product-driven gaming cycle. It is still early days in terms of management's mission to migrate to a more experiential model, which is where we locate the value. Although the share price has halved on short-term delays, on the main issue the prospects, the execution risks, and the upside associated with success remain intact.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV/EBITDA (x)	Yield (%)
07/15	866.6	46.9	38.0	18.5	14.7	1.2	N/A	68.4
07/16	822.5	28.0	16.4	8.8	3.4	2.4	N/A	15.9
07/17e	780.3	8.4	(3.6)	(1.6)	1.0	N/A	N/A	4.7
07/18e	789.9	13.4	0.8	0.4	-	56.5	N/A	N/A

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

Early days in the strategic transition

In our April initiation we made the case that Game Digital (GMD), once exclusively a high street retailer, is committed to a strategy of developing income streams that give independence from the traditional gaming cycle. This involves developing closer relationships with the interest group of users, including experiential services such as BELONG gaming arenas and the Insomnia gaming conference with over 50,000 attendees. Execution of the strategy is a journey that will take until FY20. And since GMD is leading a development of its market, there are significant execution risks attached to its strategy. This was never a short-term investment.

Trading update: Short-term timing delays

In a trading update, Game Digital has warned that UK supply shortages for the successful Nintendo Switch console will have an impact on H2 results. There are related negative effects caused by the hiatus: principally sales of related software, but also items such as accessories and preowned goods. And the supply shortage is likely to have a knock-on effect into FY18. There is a slight delay in the roll-out of BELONG in-store gaming arenas. However, these are essentially timing issues and other aspects of management's transition strategy remain on course. We downgrade revenue by 4.0% in FY17 and 2.9% in FY18, which on the heavy operational gearing means EBITDA reductions of 53% and 29%, respectively. We are assuming that dividends will be passed until FY20 to prioritise cash for growth.

Valuation: The near term does not change the game

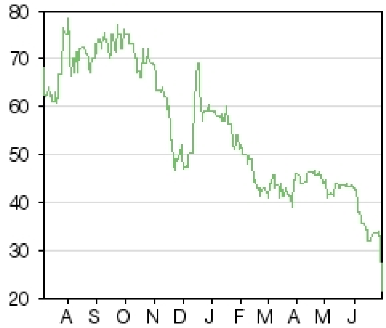
Our three valuation metrics are peer comparison, DCF and sum of the parts. Increasingly peer comparison has little relevance while GMD is so early in its change strategy. Our DCF valuation is more relevant as it reflects the expected development of cycle-independent income streams, as well as the execution risks. These, we believe, are not materially changed by the current downgrade and so the reduction is relatively minor. In our sum of the parts exercise, we separate out the growth from the non-growth components of the business, valuing the latter as a perpetuity. Our blended valuation across the three metrics is 83p, down from 93p.

4 July 2017

Price	**21.50p**
Market cap	**£37m**

Net cash (£m) at 28 January 2017	69
Shares in issue	170.9m
Free float	55%
Code	GMD
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(50.0)	(53.3)	(68.6)
Rel (local)	(48.6)	(53.4)	(72.4)
52-week high/low		78.5p	21.5p

Business description

Game Digital is the leading omni-channel specialist retailer of video games in the UK and Spain, with 311 stores in the UK, 270 stores in Spain and over 30% market share.

Next events

Final results	October 2017

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Game Digital is a research client of Edison Investment Research Limited

Trading in the second half of FY17

Game Digital's trading statement released on 30 June 2017, a month before year end, centred on supply issues with the Nintendo Switch console. The Switch, launched in March 2017, received industry acclaim for breaking new technical ground. Its premise is to function both as a console and a handheld device, allowing the user to transition from playing games at home to using them on the go.

The Switch: Problems of success

Nintendo told the press that global sales of the Switch to its March year-end surpassed its own expectations, with 2.7m units shipped against a target of 2m. With demand outstripping supply, the company is stepping up manufacturing production ahead of the Christmas buying period. Its forecast for this financial year remains 10m units, although analysts expect it is targeting substantially higher numbers (source: FT 28 May 2017). This is clearly good news for Nintendo, and its share price is up 61% since the end of March. It is also likely to boost publication of related content. We think it is overwhelmingly likely that Nintendo will increase production, in part to support sales of its own major related software release Super Mario Odyssey.

Implications of the downturn: H2 expectations disappointed

In its interim results released on 29 March, GMD stated that the Switch launch had brought impetus to the market generally, and that management anticipated the overall UK market to remain positive during the rest of 2017, underpinned by the successful launch and continued consumer demand for the Nintendo Switch, as well as the planned launch of Xbox Project Scorpio (now named as Xbox One X) and a stronger slate of new titles later in the year. The retail mint market in first seven weeks of GMD's second half (ie, broadly the months of February and March) had been up 22% in the UK and 51% in Spain. However, going forward, continuation of the positive momentum would be "highly dependent" on stock availability.

These numbers indicated that despite the supply risks there were reasonable grounds for expecting that positive progress would be retained through the second half. The reality, however, is that this has not happened. Whereas Spain has continued to trade strongly (the Spanish games market as a whole is up 19% y-o-y for GMD's H2 to date), and the supply of the Switch has not been such an issue in Spain, supply difficulties have affected sales in the UK, where the market fundamentals are not as positive.

The Switch supply issue in the UK can therefore be summarised in four points:

- Early sales of the Switch appeared to justify higher expectations for the second half;
- Global popularity for the device appears to have created a worldwide shortage;
- The UK is a comparatively small market; and
- The manufacturer is increasing production ahead of the Christmas period.

The effect of this on GMD has been that not only hardware but more importantly related software sales have been lower than expected. It was always foreseen that the launch of a new console would depress sales of competitive technologies such as Xbox and PlayStation as well as Nintendo's existing products. This situation is exacerbated if availability following the launch is delayed. In addition the launch date of Microsoft's upcoming product, the Xbox One X (previously known as Project Scorpio), was announced on 12 June 2017 as 7 November 2017. Microsoft confirmed its technical properties in a presentation at the E3 games conference, supporting its claim that it is the most powerful console ever made, overtaking the Sony PlayStation 4 Pro, launched last year.

We understand that stock allocations of the Switch between retailers have not changed significantly, so we do not believe this situation reflects an issue in relation to GMD's market share within the UK market.

In terms of core market sales, GfK UK market data for the first 26 weeks of the calendar year indicate that total hardware and software retail sales of the industry-leading PlayStation (PS4, PS3) and Xbox (XBO, XB360) are down as a whole c 16% year-on-year. However, this is probably a timing issue reflecting a comparatively weak first calendar half for content releases. We would expect the situation to correct in H2 with the release of several strong titles such as Destiny 2, Battlefront 2 and Call of Duty. This supports the view that calendar 2017 will be a year of two halves, and that IHS/IDG forecasts early this year suggesting core hardware and software close to flat year-on-year for calendar 2017 as a whole may yet be proved correct.

In addition to the direct effect on hardware and related software sales, there are indirect effects on other product categories. The Pre-owned category is affected in the same way as mint content and hardware sales, by customers further delaying purchases in anticipation of more attractive releases. The Accessories category is linked to hardware sales as it includes items such as controllers, headsets, plugs, connectors and other parts that are commonly sold along with new hardware.

Taking all factors together, management is now guiding for gross transaction value (GTV) growth in H2 to 5-6% (on a 52-week basis), which compares with our previous forecast assumption of 17%. As a result, EBITDA for the year is now expected to be substantially below previous expectations.

Development of new BELONG in-store gaming arenas is progressing, and the concept now trades in 12 locations, with an expectation of 20 in the full year. This is lower than our forecast assumption of 30, although we did not expect significant profit contribution in the year from these developments. This means, however, that there is a lower base of developed arenas going into FY18 than we had expected.

Sensitivities

Clearly GMD's change strategy embodies significant execution risk. Also, outcomes in this fast-changing market could differ from market projections, whether favourably or unfavourably:

- We follow market forecasts that assume an upturn in core markets in calendar 2019, affecting the company's results in FY20. The reality of timing and quantum could be different.
- Further advances in online gaming technology could increase the rate of digital adoption and decrease the size of the physical gaming community.
- Product-led changes such as demand for console releases, an unexpected impact from VR, or emergence of a category-killer product could cause unexpected market behaviour. Successful launches of major games titles (eg Grand Theft Auto) can also have a significant effect on results. Similarly, the failure of a major gaming title can adversely impact sales and profitability.
- The company's development of new markets such as events, esports and BELONG could have a greater or lesser effect on results than we have assumed.
- Operating leverage is high, so earnings may be volatile, although estate reductions could reduce that.

Revised forecasts

As a result of the factors explained in the trading statements we are downgrading our FY17 GTV and revenue forecast for the whole of FY17 by c 4%. Gross profit is affected at a blended margin of 23%. However, EBITDA is highly geared to gross profit, causing a 53% impact on EBITDA for the year. The factors affecting the final months of FY17 will likely persist into particularly the first half of FY18, where we lower our revenue and EBITDA forecasts by c 3% and 29%, respectively. We assume that the company will wish to prioritise cash for growth in the period until FY20 and, as a result, we have removed dividends from the FY17 final from our forecast.

Exhibit 1: Forecast changes

	GTV (£m)			Revenue (£m)			EBITDA (£m)			PBT (£m)			EPS (p)			DPS (p)		
	From	To	±	From	To	±	From	To	±	From	To	±	From	To	±	From	To	±
7/16	923.3	923.3	N/A	822.5	822.5	N/A	28.0	28.0	N/A	16.4	16.4	N/A	8.8	8.8	N/A	3.4	3.4	N/A
7/17e	923.8	885.5	-4.1%	812.6	780.3	-4.0%	17.9	8.4	-53.2%	5.9	(3.6)	-160.2%	2.7	(1.6)	-160.2%	2.0	1.0	-50.0%
7/18e	930.9	901.8	-3.1%	813.2	789.9	-2.9%	19.0	13.4	-29.4%	6.4	0.8	-86.7%	2.9	0.4	-86.7%	2.0	-	N/A

Source: Edison Investment Research

Valuation

In our initiation note we addressed valuation on three metrics: peer comparison, DCF and sum of the parts.

Peer comparison

Because of the low level of GMD's pre-tax profit forecast in FY17 and FY18, peer comparisons do not currently give a meaningful valuation on this basis. However, the closest peer, US operator GameStop, trades on an EV/EBITDA of 3.7x for both years one and two. This implies a valuation of 46p for GMD. We also compare GMD with UK small caps serving special interest groups: Games Workshop, Goals Soccer Centres, Everyman Media Group and Focusrite. These trade on an average year one EV/EBITDA of 12x, falling to 11x in year two. That implies an average GMD value of 117p. However, based on EV/EBITDA our blended peer valuation is now 82p. We previously had peer valuations averaging 89p.

DCF valuation: Valuing the medium-term strategy

We believe DCF is an appropriate metric because it reflects the medium-term strategy as well as risks. We apply a high 15% WACC reflecting the inherent execution risk. The setbacks reflected in GMD's trading statement do not, we believe, have an impact on the achievability or timing of this plan, and they therefore have a relatively minor effect on the valuation metric, producing a valuation of 81p, down from 91p in our initiation, on the same assumptions.

Sum of the parts: Focus on the growth element

We explained at initiation that our preferred measure is to create a valuation of growth categories valuing their cash flows independently from non-growth categories. On this basis, applied consistently, we value the growth businesses at 76p and non-growth operations at 10p, for a total of 86p (previously 100p).

Averaging all three metrics, we define a blended valuation of 83p (previously 93p).

Exhibit 2: Financial summary

Accounts: IFRS; year end: July; £m	2015A	2016A	2017E	2018E	2019E	2020E
Profit and Loss statement						
Total revenues	866.6	822.5	780.3	789.9	800.9	1,007.1
Cost of sales	(652.9)	(612.7)	(582.4)	(586.6)	(589.0)	(763.6)
Other income/(expense)	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals and adjustments	(12.2)	(11.5)	(4.7)	(9.1)	(9.1)	(9.1)
Depreciation and amortisation	(8.5)	(10.5)	(11.0)	(11.9)	(13.0)	(15.1)
Reported EBIT	29.9	8.4	(11.7)	(7.7)	(2.4)	22.4
Finance income/(expense)	(0.4)	(1.1)	(1.0)	(0.6)	(0.6)	(0.8)
Exceptionals and adjustments	(3.7)	(2.4)	4.4	0.0	0.0	0.0
Reported PBT	29.5	7.3	(12.7)	(8.3)	(3.0)	21.6
Income tax expense (includes exceptionals)	(4.4)	(1.3)	0.9	(0.2)	(1.3)	(6.8)
Reported net income	25.1	6.0	(11.8)	(8.4)	(4.3)	14.9
Basic average number of shares, m	168.3	168.9	170.9	170.9	170.9	170.9
Basic EPS, p	12.7	3.3	(4.9)	(5.0)	(3.3)	4.8
Dividend per share, p	14.7	3.4	1.0	0.0	0.0	4.0
Adjusted EBITDA	46.9	28.0	8.4	13.4	19.7	46.6
Adjusted EBIT	38.4	17.5	(2.6)	1.4	6.7	31.5
Adjusted PBT	38.0	16.4	(3.6)	0.8	6.1	30.7
Adjusted diluted EPS, p	18.5	8.8	(1.6)	0.4	2.8	13.8
Balance sheet						
Goodwill	0.0	0.0	0.0	0.0	0.0	0.0
Intangible assets	61.0	56.7	43.0	29.3	15.6	1.9
Other non-current assets	0.2	2.2	2.2	2.2	2.2	2.2
Total non-current assets	80.4	75.7	68.0	63.0	57.5	50.2
Cash and equivalents	63.1	48.8	55.4	54.5	56.8	69.3
Inventories	66.8	76.1	73.1	73.7	74.0	95.9
Trade and other receivables	17.8	20.4	19.6	19.8	20.1	25.3
Other current assets	0.9	0.7	0.7	0.7	0.7	0.7
Total current assets	148.6	153.1	148.8	148.7	151.6	191.1
Non-current loans and borrowings	0.1	3.1	3.1	3.1	3.1	3.1
Other non-current liabilities	5.7	4.4	1.9	1.9	1.9	1.9
Total non-current liabilities	5.8	7.5	5.0	5.0	5.0	5.0
Trade and other payables	93.8	85.9	82.5	83.1	83.5	108.2
Current loans and borrowings	0.0	7.2	7.2	7.2	7.2	7.2
Other current liabilities	3.2	1.3	1.3	1.3	1.3	1.3
Total current liabilities	97.0	94.4	91.0	91.6	92.0	116.7
Non-controlling interest	0.0	0.0	0.0	0.0	0.0	0.0
Cashflow statement						
Cash from operations (CFO)	44.1	6.2	11.4	15.6	19.6	33.6
Capex	(11.3)	(13.3)	(12.4)	(16.0)	(16.6)	(16.9)
Acquisitions & disposals net	(12.4)	(1.5)	13.3	0.0	0.0	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)	0.9	(16.0)	(16.6)	(16.9)
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)	(5.7)	(0.6)	(0.6)	(4.2)
Cash from financing activities (CFF)	(39.3)	(12.4)	(5.7)	(0.6)	(0.6)	(4.2)
Increase/(decrease) in cash and equivalents	(19.1)	(21.0)	6.6	(0.9)	2.4	12.4
Currency translation differences and other	(3.1)	1.0	0.0	0.0	0.0	0.0
Cash and equivalents at end of period	63.1	43.1	49.7	48.8	51.1	63.6
Net (debt) cash	63.0	38.5	45.1	44.2	46.5	59.0
Movement in net (debt) cash over period	63.0	(24.5)	6.6	(0.9)	2.4	12.4

Source: GMD accounts, Edison Investment Research

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