EDISON

Game Digital

Full year results

Sales recovery sees strategy on track

Retail

Results confirm that the sales recovery signalled in August has been fully realised in terms of profit delivery. The business transformation strategy is on track, and Game Digital is successfully developing future growth areas such as digital content, virtual reality, BELONG arenas, and tournaments. With significant euro exposure, and buoyant retail growth in Q1 of the current year, an FY18e EV/EBITDA valuation of 2.1x looks misplaced.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV/EBITDA (x)	Yield (%)
07/16*	821.9	26.4	14.8	10.7	3.4	3.7	1.1	8.5
07/17	782.9	8.0	(4.3)	(3.7)	1.0	N/A	3.2	2.5
07/18e	793.2	12.3	0.2	0.1	0.0	N/A	2.1	N/A
07/19e	796.3	15.0	1.9	0.9	0.0	45.9	1.7	N/A

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

Switch comes through

The second half saw strong trading recovery, led by the easing of the Nintendo Switch supply bottleneck that affected H1. After 36 weeks, Switch is confirming its significance, with UK and Spain market volumes heading for 3-4m units three years out, against 1.7m units of combined Xbox and PlayStation in FY17.

Results on expectation

EBITDA met our £8.0m forecast on the Switch supply improvement. Content sales stabilised including 16.8% annual growth in digital content, showing Game Digital's traction in new technology. Spain (37% of revenue) improved euro growth, further enhanced by FX rates. Gross margins reduced 60bp y-o-y on higher mix of new lower-margin products. Operating costs grew only 2.8% after £7.4m of UK savings. Led by strong unit sales of Switch and, very recently, the XBOX One X, total retail sales are up 5.4% for the first 15 weeks of FY18.

Transformation strategy on track

Game Digital (GMD) is energetically pursuing its strategic plan in four areas: retail, services, digital and efficiency. Standout FY17 achievements were: 18 BELONG arena openings (35 are targeted in FY18), and 49 renewed leases, 39 at improved terms. A further 221 lease events by December 2018 give management leverage.

Strong balance sheet

GMD's balance sheet is reassuringly strong, with net cash of £42.6m. The company has total facilities of c £86m.

Valuation: EBITDA multiple of 2.1x is too low

With net cash of 25p per share, the market values the business at only 2.1x FY18e EBITDA, which appears inappropriate, even taking into account the execution risks still lying ahead. Although we have trimmed our FY18 EBITDA forecast by £1m, it still represents 54% year-on-year growth. Our valuation is a blend of three metrics: DCF, peer comparison and sum-of-the-parts, averaging 80p (previously 83p).

15 November 2017

Price	**40.1p**
Market cap	**£69m**

Net cash (£m) at end July 2017	42.6
Shares in issue	170.9m
Free float	55%
Code	GMD
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	11.1	62.1	(34.8)
Rel (local)	12.9	60.8	(41.1)
52-week high/low		69.0p	19.3p

Business description

Game Digital is the leading omni-channel specialist retailer of video games in the UK and Spain, with 304 stores in the UK, 268 stores in Spain and over 30% market share.

Next events

AGM trading update	Mid-January 2018
Interim results	Late March 2018

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Edison profile page

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Final results

Second half trading improvement: Profit delivery as expected

GMD has reported results in line with our expectations, after a decisive trading recovery in H2:

Exhibit 1: Summary of results: In line with expectations

£m	FY16*	FY17	±	As forecast
GTV	912.6	891.0	-2.4%	885.5
Revenue	812.5	782.9	-3.6%	780.3
Gross Profit	217.4	205.1	-5.7%	N/A
Operating costs	(191.8)	(197.1)	2.8%	N/A
EBITDA	25.6	8.0	N/A	8.0
PBT	14.0	(4.3)	N/A	(4.0)

Source: GMD. Note: *FY16 52 weeks, as reclassified.

The second-half pick-up was largely caused by the expected supply improvement to the new Nintendo Switch console which, following launch in March, had suffered shortages in H1 as a result of significant demand far outstripping demand.

Exhibit 2: First- to second-half GTV analysis – decisive recovery led by hardware

£m	H116	H216	FY16*	H117	H217	FY17	Growth H1	Growth H2	Growth FY
Content	267.2	133.8	401.0	262.1	133.9	396.0	-1.9%	0.1%	-1.2%
Pre-owned	104.8	81.0	185.8	95.7	78.6	174.3	-8.7%	-3.0%	-6.2%
Accessories & Other	78.8	44.7	123.5	90.9	55.6	146.5	15.4%	24.4%	18.6%
Subtotal	**450.8**	**259.5**	**710.3**	**448.7**	**268.1**	**716.8**	**-0.5%**	**3.3%**	**0.9%**
Hardware	157.2	45.1	202.3	117.6	56.6	174.2	-25.2%	25.5%	-13.9%
Total	**608.0**	**304.6**	**912.6**	**566.3**	**324.7**	**891.0**	**-6.9%**	**6.6%**	**-2.4%**
UK	447.7	201.0	648.7	366.7	195.3	562.0	-18.1%	-2.8%	-13.4%
Spain	156.4	101.4	257.8	191.0	124.8	315.8	22.1%	23.1%	22.5%
Events, Esports & Digital	3.9	2.2	6.1	8.6	4.6	13.2	120.5%	109.1%	116.4%
Total	**608.0**	**304.6**	**912.6**	**566.3**	**324.7**	**891.0**	**-6.9%**	**6.6%**	**-2.4%**

Source: GMD, Edison Investment Research. Note: *FY16 52 weeks.

The major takeaways from this analysis are:

- Hardware turned round significantly in H2, both as a result of Switch supplies improving, and against H1 demand for other consoles that had been weak in anticipation. Hardware is lower margin than other categories, but the margin on a new launch such as Switch is up to double that on older models (see Gross profit, below). It is also a leading indicator of demand for content and other categories.
- Content, which is the main driver of contribution, stabilised with 0.1% growth in H2 against a 1.9% decline in H1. Within this, a 16.8% growth in digital content for the year effectively compensated in value terms for an 8.1% decline in physical software. This is an important positive indicator for the future because it shows that Game Digital is successfully attracting customers to purchase digital content rather than downloading it online from other sources.
- The UK GTV decline in H1 was largely mitigated in H2, while Spain produced strong £ growth in both halves. Although this was flattered on translation to sterling, there was significant constant currency GTV growth in Spain, rising from 3.1% in H1 to 12.8% in H2, to give 6.9% for the full year. Here too, the improvement was led by Switch, although there was also a dramatic pick-up in pre-owned technology sales, up 48.5% in H2 against 33.3% in H1.

This therefore indicates a combination of positive developments which, as well as fulfilling the expected resolution of the Switch supply situation, shows underlying trends moving in GMD's direction.

The 2.4% overall decline in GTV translates to a 3.6% decline in revenue, the difference attributable to the increase in digital content, which attracts a lower revenue share.

Gross profit: Declining margin on top-line opportunities

Gross profit, down 60bp overall, combined several factors, all of which are a function of market developments that are overall positive for GMD:

Exhibit 3: Gross margin analysis – margins settle on mix of new product types

	FY16	FY17	±	
Revenue (£m)	812.5	782.9	-3.6%	
Gross profit (£m)	217.4	205.1	-5.7%	
GP %	26.8	26.2	(0.6)	ppts
Gross margin analysis by category (%):				
Content	33.1	32.3	(0.8)	ppts
Pre-owned	35.8	33.5	(2.3)	ppts
Accessories & Other	34.2	29.4	(4.8)	ppts
Subtotal	34.1	31.9	(2.2)	ppts
Hardware	4.2	6.1	1.9	ppts
Total	26.8	26.2	(0.6)	ppts

Source: GMD, Edison Investment Research. Note: FY16 52 weeks.

The reported decline of 0.6 percentage points was net of a 1.9 point improvement in hardware on the swing to new models, and a currency benefit worth around one percentage point. Elsewhere, lower margins were associated with higher mix of new product types. In content they related to the increased digital volumes. In pre-owned categories they related to a higher mix of new format (Xbox One and PlayStation 4) related products which, while reflecting the increased technical sophistication of the market, attract lower margins. In Accessories & Other they were affected by the advent of virtual reality devices, which are of course likely to be a significant top-line opportunity in the gaming space over time.

Operating costs: Savings programme mitigates headwinds

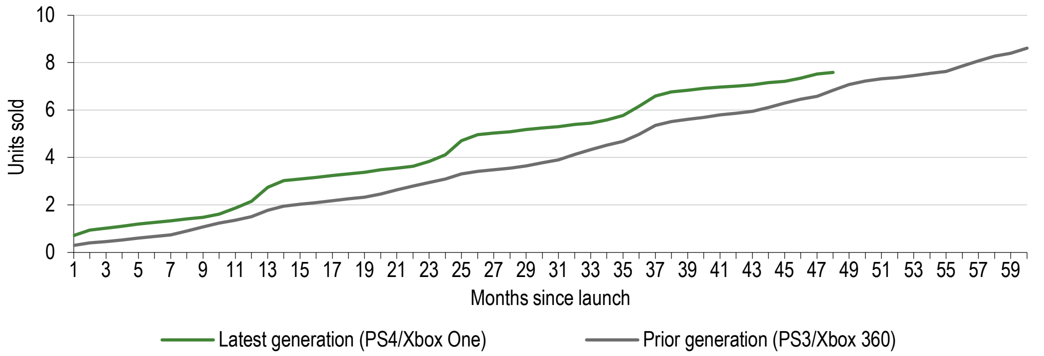
Operating costs, before depreciation and amortisation, adjusting and exceptional items, and on a 52-week basis, rose 2.8% from £191.8m to £197.1m. Around £11m, or 5% of costs, were saved by the UK programme, comprising store efficiencies, rent and rates, distribution efficiencies, marketing and overheads, but against that £3.7m of headwinds arose from wage inflation, investment in multi-channel and customer service improvements, and first time office leaseback costs following the sale in October 2016. Retail costs in Spain, though only up 4% in currency terms against GTV growth of 6.9%, were up 18.2% or £8.6m in sterling terms. A further increase of £4m resulted from the rapid expansion of the Events, Esports & Digital operation, including the first-time inclusion of BELONG and the scaling up of Multiplay operations, both participation and digital.

Market trends are net positive

While the difference between the first and second half result is encouraging, underlying market trends support the business strategy. Among the underlying positive trends becoming apparent are:

- the installed base is on a consistent growth trend, with the latest generation of consoles selling well:

Exhibit 4: Latest generation (PS4/Xbox One) vs prior generation (PS3/Xbox 360), UK



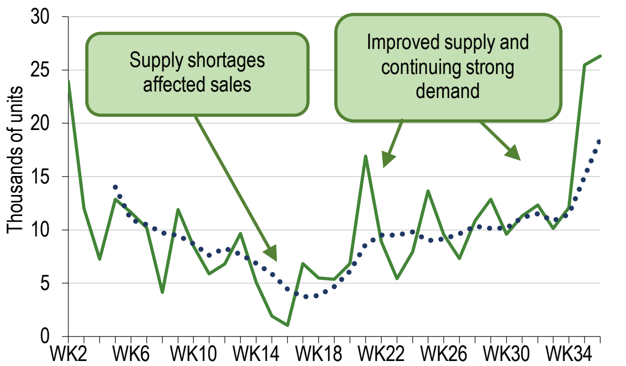
Source: GMD

- GMD has good traction in non-console categories such as PC gaming, digital content, VR, phones and tech, merchandise and services. These categories have grown at a three-year CAGR of 24% to now represent 26% of total GTV.
- within this, digital content sales up 16.8% demonstrate GMD's competitiveness in this area and the fact that customers are making physical purchases of digital content rather than the cumbersome path of downloading it online.
- there is a good market presence of leading games such as FIFA, Call Of Duty, Destiny 2 and Assassin's Creed. In FY17 the software market was 11.9% down y-o-y in the UK and up 3.0% in Spain. However, in FY18 to date the UK software market is up 1.4% and the Spanish market up 17.4% (source GMD).

Switch confirms expectations

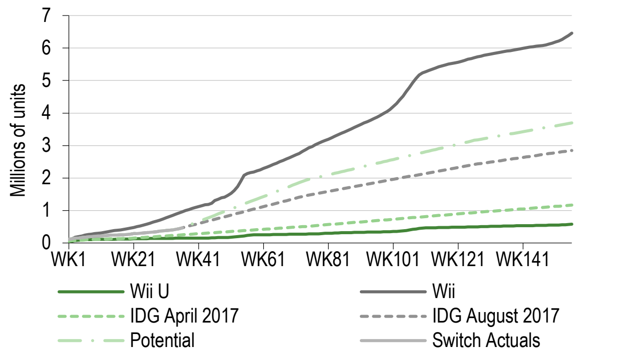
The release of Switch is very promising with, as expected, experience after 36 weeks placing it midway between the all-time record-holder the Wii and the less successful Wii U. Extended to three years this indicates upgraded projected sales volumes in the UK and Spain of 3-4m units (source IDG forecasts quoted by GMD), which compares with 1.7m units of combined Xbox and PlayStation sales in FY17.

Exhibit 5: UK and Spain Nintendo volumes – 36 weeks



Source: GMD

Exhibit 6: UK and Spain Nintendo volumes – 3 years



Source: GMD

In addition, the software tie ratio of 3.0 times is in line with the Wii (3.1 times), showing good prospects for content sales into the future.

Against these, negative trends emerging are:

- Frequency of purchase: as games become more sophisticated there is a tendency to buy new games less frequently. The new normal of 3 games compares with a historic record on old technology closer to 4. Conversely, players are investing in add-ons.
- Console games are not the automatic choice for the uninitiated, with increasing spread into non-console technology (see above). This represents an overall headwind for the console market per se.

Transformation strategy on track: Energetic development

In our initiation The Long Game, published in April 2017, we argued that GMD is engaged in a strategy to transform the company from its former role as a purveyor of hardware and content product, to an organisation that is engaged with its interest group and with a spread of offerings that includes experiential as well as physical product. The company is delivering on its strategy with a range of actions falling under four headings:

1. **Retail development**

   i. **Delivering a compelling customer proposition:** GMD maintains its market leading position, with 304 stores in the UK and 268 in Spain. In FY17 it enhanced the proposition with the introduction in May of the subscription-based Elite reward scheme (60,000 members to date) as well as the existing Reward scheme (4.5 million members). It has further developed privileged relationships with its major suppliers, enabling it to market exclusive editions on high-selling titles. Reflecting the increasing significance of the pre-owned category, GMD in September introduced an online trade-in service.

   ii. **Building new categories and services:** GMD has c 60% of the digital console market in the UK and Spain and, supporting the 16.8% growth in digital sales, has expanded its digital range and improved related marketing. It has also expanded its pre-owned devices and accessories, and non-console products such as PC products, virtual reality equipment and accessories. The company has launched a consumer finance proposition for higher-value items.

   iii. **Developing the online and multi-channel proposition:** GMD has invested in its online teams and e-commerce platforms, also enhancing the click and collect service and relaunching the app.

   iv. **Optimising the store estate:** in FY17 49 leases were renewed, with rents in 39 reduced by an annualised £1.4m. It is notable that the company has 221 lease events in the period to December 2018, out of 304 UK stores. This gives management significant leverage both to reduce property costs (it has saved £4.7m since commencement of the programme and targets a further £2m in FY18) and to develop its estate to the optimum format, including BELONG (below). The company is also rolling out a new store efficiency programme, and is introducing measures to better utilise limited store space. Trial concessions are operating with WH Smith and Maplin.

2. **Expand live and online gaming services**

   BELONG is now in 18 stores and management has accumulated significant experience. We understand that the best returns are being achieved in busy high street or city centre locations, which is likely to focus current development priorities for its target of 35 developments in FY18. The Insomnia festival has been further developed in the year and attracts an audience of up to 155,000. Between this level and BELONG, there exists a network that management has developed from the non-digital business of its Multiplay acquisition of eSports events across the UK and in Spain. Total events sales grew 48% in FY17 to £7.1m.

3. **Develop and grow digital enterprise services**

   Although the digital B2B operation of Multiplay has been placed under strategic review, this is from a position of strength in which sales grew by 114% y-o-y to £4.5m.

4. **Optimise organisational efficiency while investing for the future**

   We note above that the company achieved UK cost savings of £11m. These consist of the annualisation of FY16 savings amounting to £6.2m, and £4.9m of additional savings in FY17. In addition, total savings of £8.3m are targeted for FY18 across property, payroll and other areas.

Forecast: Retaining significant growth expectation

Exhibit 7: 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	±
07/16	923.3	923.3	N/A	821.9	821.9	N/A	28.0	26.4	N/A	16.4	14.8	N/A	8.8	10.7	N/A	3.4	3.4	N/A
07/17	885.5	891.0	0.6%	780.3	782.9	0.3%	8.0	8.0	0.0%	(4.0)	(4.3)	7.5%	(1.8)	(3.7)	106.2%	1.0	1.0	N/A
07/18	901.8	912.5	1.2%	789.9	793.2	0.4%	13.4	12.3	-8.5%	0.9	0.2	-77.2%	0.4	0.1	-77.0%	0.0	0.0	N/A
07/19	914.9	916.9	0.2%	800.9	796.3	-0.6%	19.7	15.0	-23.7%	6.1	1.9	-68.1%	2.8	0.9	-68.8%	0.0	0.0	N/A

Source: Edison Investment Research

We make no material changes to our forecast GTV and revenue. However, we reduce FY18 forecast EBITDA by £1.1m to £12.3m, mainly as a result of rolling forward gross margin mix effects. Resulting EBITDA of £12.3m still represents 54% growth on FY17.

Balance sheet

Net cash at July 2017 was £42.6m, a £4.1m increase year-on-year. The main elements were cash generated by operations of £10.0m, net interest and tax (£2.3m), capex (£11.6m) and proceeds from the sale and leaseback of the head office of £13.3m.

At July 2017 GMD had undrawn total facilities of c £77m, with a UK asset-backed revolving loan facility of £50m (with peak extension to £75m) and short-term Spanish facilities of €30.0 million. The latter have been extended to €40.6m to cover peak trading. As a result, the company's total facilities currently amount to c £86m, of which c £75m is undrawn.

Valuation

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

Peer comparison

Since our pre-tax profit forecasts for GMD are low for FY18 and FY19, peer comparisons on P/E ratios do not currently give a meaningful valuation. We therefore compare with peers on an EV/EBITDA basis. The only close peer in the sense of being a gaming equipment retailer is the US operator GameStop. GameStop trades on an EV/EBITDA of 3.2x for both years one and two, compared with GMD's valuation of 2.1x falling to 1.7x. While low compared with other retailers, this in itself would imply a valuation of 50p for GMD. We also compare GMD with UK small-cap companies serving special interest groups: Games Workshop, Goals Soccer Centres, Everyman Media Group and Focusrite. These trade on an average year one EV/EBITDA of 13.7x, falling to 12.1x in year two. That implies an average GMD value of 125p. Taking an average between these two levels, our peer valuation is 88p (previously 82p).

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 take a cautious approach in extending our forecast to 10 years, stepping down assumed GTV growth from 16% in FY20 to 10% in FY21 and 5% thereafter, fading in the last three years to 2% in the terminal period (this represents a later phasing of growth, which we previously showed as 26% in FY20 followed by 4% in FY21 and thereafter, again fading to a terminal 2%). We apply a high 15% WACC reflecting inherent execution risks. This results in a valuation of 72p (previously 81p).

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 separately from non-growth categories. On this basis, applied consistently, we value the growth businesses at 70p and non-growth operations at 10p, a total of 80p (previously 86p).

Averaging all three metrics, we define a blended valuation of 80p (previously 83p).

Exhibit 8: Financial summary

Accounts: IFRS, Year-end: July, £m	2015	2016*	2017	2018e	2019e	2020e
Profit and Loss statement						
Total revenues	866.6	821.9	782.9	793.2	796.3	920.4
Cost of sales	(652.9)	(612.7)	(577.8)	(586.8)	(589.1)	(691.2)
Other income/(expense)	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals and adjustments	(12.2)	(12.9)	(5.7)	(9.6)	(9.6)	(9.6)
Depreciation and amortisation	(8.5)	(10.5)	(11.0)	(11.4)	(12.5)	(14.6)
Reported EBIT	26.2	3.0	(8.7)	(8.8)	(7.0)	8.9
Finance income/(expense)	(0.4)	(1.1)	(1.3)	(0.6)	(0.6)	(0.8)
Exceptionals and adjustments	(3.7)	(3.8)	3.9	0.0	0.0	0.0
Reported PBT	25.8	1.9	(10.0)	(9.4)	(7.7)	8.1
Income tax expense (includes exceptionals)	(4.4)	1.3	(2.1)	(0.0)	(0.4)	(3.9)
Reported net income	21.4	3.2	(12.1)	(9.4)	(8.1)	4.2
Basic average number of shares, m	168.3	168.9	169.7	170.9	170.9	170.9
Basic EPS, p	12.7	1.9	(7.1)	(5.5)	(4.7)	2.4
Dividend per share (p)	14.7	3.4	1.0	0.0	0.0	4.0
Adjusted EBITDA	46.9	26.4	8.0	12.3	15.0	33.1
Adjusted EBIT	38.4	15.9	(3.0)	0.8	2.6	18.5
Adjusted PBT	38.0	14.8	(4.3)	0.2	1.9	17.7
Adjusted diluted EPS (p)	18.5	10.7	(3.7)	0.1	0.9	7.9
Balance sheet						
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	63.3	57.8	50.5
Cash and equivalents	63.1	48.8	47.2	48.4	48.1	57.8
Inventories	66.8	76.1	81.2	75.1	75.4	88.5
Trade and other receivables	17.8	20.4	23.5	19.9	20.0	23.1
Other current assets	0.9	1.7	1.7	1.7	1.7	1.7
Total current assets	148.6	154.1	153.6	145.2	145.2	171.1
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	89.5	89.9	105.5
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	99.8	100.2	115.8
Equity attributable to company	126.2	126.9	109.2	103.2	97.4	100.5
Cash flow statement						
Cash from operations (CFO)	44.1	3.2	9.1	12.1	16.9	30.9
Capex	(11.3)	(13.3)	(11.6)	(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)	1.7	(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)	(4.3)	(0.6)	(0.6)	(4.2)
Cash from financing activities (CFF)	(39.3)	(12.4)	(4.3)	(0.6)	(0.6)	(4.2)
Increase/(decrease) in cash and equivalents	(19.1)	(24.0)	6.5	(4.5)	(0.3)	9.7
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	42.7	42.4	52.1
Net (debt) cash	63.0	38.5	42.6	38.1	37.8	47.5
Movement in net (debt) cash over period	63.0	(24.5)	4.1	(4.5)	(0.3)	9.7

Source: Game Digital accounts, Edison Investment Research. Note: *Restated.

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