GameStop

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Brian Karimzad: All right. Good morning, everybody. I am Brian Karimzad from Goldman Sachs research, and it's my pleasure to welcome our next guest, Rob Lloyd, the Chief Financial Officer of GameStop. Rob, welcome this morning.

Rob Lloyd: Thank you. Good morning.

Brian Karimzad: So, we'll get started here. We only have about 30 minutes. The thing I think that's been in the headlines, and certainly you've had to respond to, at least in conversations with folks, have been the questions about technology and the used game business.

I think maybe one way to start the conversation on your end would be to help us understand why a game publisher would want to see a healthy and growing preowned software business at GameStop.

Rob Lloyd: Sure. The publishers understand that a healthy preowned games market helps them to sell more new games. And the reason is that our buy-sell-trade model puts over a billion dollars worth of currency in the customers' hands every year, and that currency goes primarily towards the purchase of new games.

So by offering trades to customers, we sell more new games for the publishers. So the publishers understand that it's important to have that ecosystem in place.

Brian Karimzad: Fair enough. Do you have any sense internally how vital this is to the sampling and the trial of the new product or any kind of nuances within that?

Rob Lloyd: Well, we think it's important because what we see from consumers is they will buy new games, and some games you can play through faster than others, and so those games will start to come back in trade. And then when customers are done playing their games, they will bring them back and trade them in.

I think what publishers understand, and what we've helped to educate them on through the years, is that it's really only about 4% of our used-game sales are games that were released in the last 60 days. So it does not have a big impact on the sales of new product. So that's why publishers, I think, understand how important the preowned business is to them.

Brian Karimzad: Okay. That's fair. I know you can't really speak yet specifically to what publishers and manufacturers have told you, but is it your sense that some decisions have been made, in terms of how to handle authentication for new games, going forward with this potential, yet-to-be-announced, new generation that you can't fully talk about; but can you give us a sense of kind of how far along those types of conversations are? I imagine that you've been part of them, although you can't get too specific.

Rob Lloyd: Sure. Sony has said publicly that they don't intend to block used games in their next console. Microsoft has not commented on the rumors that have hit the marketplace. But over the course of the last year, we have had the opportunity to do research. There has been other research that has been done, and we've had the opportunity to share that research with the console makers and to demonstrate to them that consumers want the ability to play preowned games. They want portability in their games. They want to play physical games, and to not have those things would be a substantial reason for them to not purchase a new console.

Brian Karimzad: Any numbers you can share, in terms of the consumer insights there, you know, percentages of folks who view it as a substantial negative if that were to take place?

Rob Lloyd: I think it's approximately 60% of the customers have said they wouldn't buy a new console if it didn't play preowned games.

Brian Karimzad: Okay. Let's say, though, that one of them decides unilaterally to block it altogether with the digital authentication. I'm not saying that's going to happen, but if such a scenario were to transpire, give us a sense of how you adapt, given the kind of install base time frame -- you kind of have to ramp, there -- what the time frame would be for adapting that situation?

Rob Lloyd: Sure. We'll be able to sell the new consoles that come from Microsoft and Sony regardless of what features they have or what they do or don't allow. We'll have leading market share on the sales of those consoles. We'll adapt to what it does to the preowned business. And one of the ways that we'll do that is through a continued healthy preowned business for today's generation of consoles.

We are in the last year, or so, starting to scale down what we sell in PlayStation 2, which means that PlayStation 2 is still selling very healthfully in the preowned market in our stores for about 12 years after launch. So we see a long life cycle for the 360 and the PS3, as we move forward in the future years with these new consoles.

We're also doing other things in-store to make use of our buy-sell-trade expertise. We built a $160 million mobile business. We disclosed through the holiday season that sales year to date were $160 million, and that business didn't exist in 2011, for the most part.

So we're finding other ways to drive revenue streams in our stores and adapt to a changing marketplace.

Brian Karimzad: For you -- so that's the software side of the business. You also have a hardware preowned business. Help us understand how the margins on that may or may not differ from the software side. I don't think you've ever disclosed the relative size of that, but if there is any way you can frame that for us as we enter this new generation.

Rob Lloyd: Sure. The preowned hardware margins are essentially the same as the preowned software margins. There's not a substantial difference. And the relative size of preowned hardware is not something we've disclosed, but directionally, it's a little less than preowned software -- less than, as a percentage of the total, than new hardware is to --

Brian Karimzad: Got it.

Rob Lloyd: -- of new hardware and software.

Brian Karimzad: I understand. Let's say, though, that the double-digit, year-over-year decline that we've seen in used recently, which sounds like it's a bit of a function of supply of new software recently -- let's say that continues for a couple of years. What are some of the things that you can do in your footprint, in your cost space, and in the way you're mixing to adapt to that, and what have you considered?

Rob Lloyd: Well, we don't expect a double-digit decline, which we experienced in the holiday season, to continue. I think that -- we haven't disclosed our results for 2012, but I think you'll see that when we do. We believe that the new console cycle is going to bring a wave of trades towards those new consoles and the games that come out, as consumers need that currency to buy the new consoles.

So we don't expect the same trend to continue, but one of the reasons why we built the mobile business that we did was because we recognized the need to lessen our dependence entirely on the videogame cycle.

There are other videogame products that are coming. OUYA has a device. There's rumored to be a Steam Box, and we'll be in a position to sell those devices, as well. And so we continue to look at ways to use our store footprint to maximize our buy-sell-trade revenue and our revenue from all types of consumer electronics.

Brian Karimzad: Okay. But it is your sense that perhaps that used decline may have started to ebb in the recent period, here?

Rob Lloyd: Well, as we look forward, you -- once you get the console announcements, you typically have a period of time in which the consumer is waiting to purchase the new console. So we expect that we'll continue to see some difficult times while we wait for those consoles to launch, and that will have an effect on preowned, as well. But then with the launch of those consoles, we will see an increase in trades.

Brian Karimzad: And what kind of magnitude did you see last cycle on those increases in trades? Any sense of frame of reference there?

Rob Lloyd: Not right off the top of my head, but I can say that we're in a little bit of a different environment, in that we're two years longer into this cycle than we were the last time that consoles were launched.

Brian Karimzad: Fair enough. What about just the software market generally in 2012? What did you guys assess as the postmortem on what happened? What you forecasted certainly was not what transpired. There are a number of theories out there, ranging from secular issues, to it being supply, to a number of -- or, the economy, itself. Where would you order the factors, now that you've had a chance to look at what happened last year?

Rob Lloyd: Well, clearly the decline was greater than we anticipated, greater than many of the pundits anticipated for the market. I think supply was a big issue. There were fewer titles released during 2012 than there had been in prior years, so that was an impact.

I think what we saw was that the big titles, the Call of Duty's, Assassin's Creed's, and those blockbuster franchises, continued to sell very well and had very strong sell-through. In fact, you see year-over-year increases in most of those franchises.

The pressure, therefore, was on the catalog side of the business, the older titles that consumers come in and pick up, maybe less than $60 price point. We would expect that that kind of pressure would continue as we move into next year, but we expect that the blockbuster titles will continue to sell well.

Brian Karimzad: I know you had said initially that the first half was looking decent from a supply standpoint. As you've had further conversations with the publishers, how has that expectation shaped up?

Rob Lloyd: The first quarter had some pretty interesting titles in it -- BioShock Infinite; Dead Space 3 came out last week and performed to expectations. So we're excited about the first quarter. There were some decent titles in the first quarter of last year.

Grand Theft Auto was obviously the big title for the year. That didn't have an equivalent last year. It has, as we understand, moved to September, so that'll have a pretty strong impact in our third quarter. And then we expect to see the same kinds of third- and fourth-quarter titles that we've seen in the past. I think this is a Battlefield year, so we expect Battlefield to do well this year.

Brian Karimzad: What's been your sense that as more of these titles compress into the third, fourth quarter, have you felt that it's accretive or detrimental to the industry that more of more of these big titles have been pushed there?

Rob Lloyd: We would love to have seen some of these big titles in the second quarter, in particular. When we thought that Grant Theft was going to be in the second quarter, that was pretty exciting news. But what we tell publishers is we can sell videogames all year long, and the blockbuster titles will sell well regardless of when they're released.

Brian Karimzad: What about forecasting demand for this year? We'll have a conversation in about a month on guidance, but as you think about it and you look back at the last console transition -- I know this one has lasted a lot longer, but what are some of the factors from that last transition that you're using when you take a look at planning this year, and what are some of the other factors that we should be aware of as we think about it?

Rob Lloyd: I think it's the impact that we'll have on hardware sell-through once the consoles get announced, and then the impact that that's going to have on software, in terms of the catalog. Again, I think the blockbuster titles will continue to sell well, but you will see an impact as the consumer waits for those new consoles to hit.

Brian Karimzad: What you saw last time -- I mean, it seems pretty consistent these things launch in the fall around the holiday, and that's probably what's going to happen this time around -- as you pace through a year -- you know, the announcements I think last time happened at, what, the spring, around April, May, or so? Help us understand kind of how it started to impact the curve then, if you have a sense. I mean, did it get -- did the trough happen right before the release, itself, in the fall? Or when the announcement happened, that's when things started to downdraft? Any color there?

Rob Lloyd: Not a lot of color I can add to that without going back and checking exactly what the market numbers showed. But our expectation would be that post-announcement, you'd see an impact.

Brian Karimzad: What about your consumers? I think there are some of us out there who think, why bother with another high-definition console? Is 1080p, 60 frames a second really enough to make a difference for folks to shell out $400 when there are so many alternatives out there? In your research and speaking to your consumers, what have they told you they want to see, and what motivation they have right now to get a new piece of hardware?

Rob Lloyd: I think consumers are expecting innovation in the consoles, and I think they're waiting for innovation. I think the fact that you've seen success with tablet sales and things in the last couple of years is an indication that consumers want innovation. And we think that these consoles are going to bring that innovation.

In terms of what customers tell us about the technology and what they're interested in, it may be less about what they're hoping to see in terms of new design and new technology and more about what they expect to see carried forward.

So, customers have been very vocal, both to us and to others who have done research, as I said earlier, about the things they want to have carried forward. Their ability to play physical games and preowned games is very important to them.

Brian Karimzad: What about, then, your footprint and what it's able to handle? We haven't had a console transitioning like this, again, in, what, seven years? Your footprint is certainly different than it was back then, but also it's a larger market than it was back then. Can you help us understand if it's ready to handle what could come if we get two launches in pretty close succession, here? And would you pursue some expansion of your footprint? How would you balance that consideration against the cash returns that you're out there with right now?

Rob Lloyd: Sure. We're absolutely ready to handle one launch, two launches, whatever comes. We've got considerably more market share than we had when consoles launched in 2005 and 2006. We continue to gain share every year.

Part of the reason for that is because we've remained committed to the category. We've built a PowerUp Rewards member database of 22 million members, and we've work with publishers through the years to help to drive their launches. So we're very excited about the opportunity to launch whatever consoles come, and we're prepared to do that out of our footprint.

We see that for 2013, we might open 60 to 70 stores in selected locations, which is less than we opened in 2012. We see that there's a need in certain markets, based upon what our PowerUp customers tell us to add stores, particularly in tertiary markets. But we will also close approximately 250 stores in 2013.

We're also using our PowerUp awards database to help customers move from stores that we want to close to other nearby stores. And closing 250 stores enables us to deal with the very small percentage of stores that we have that are unprofitable, but also to close marginally profitable stores and actually make more money by moving customers to other nearby stores. We've been successful at that for two years, and we'll continue that program in 2013.

The one last thing that we'll do in 2013 is we're pursuing the purchase of about 40 former Game locations in France because Game has recently shut down their operations in the French market.

So with that, again, opening 60 to 70, acquiring about 40 in France, and then closing about 250, we expect to have a net reduction in our square footage of about 2% in 2013.

Brian Karimzad: And the net reduction, is there any geographic bias to that?

Rob Lloyd: Well, you'll have approximately 200 of those in the US. The remainder would be in international markets. Beyond that, there's not a particular geographic bias.

Brian Karimzad: Let's discuss the launch of the Wii U a bit. How satisfied were you? I think an initial concern you had was, would you get the allocations to begin with. It sounds like you got that, but if you want to comment on how satisfied you were about that. And what about the support about the product generally, and where you see it playing out over the next year or two, as the software is released.

Rob Lloyd: We were pleased with the allocation that we got through the launch. I think that for us it performed at expectations. We used the wait list that we created in the fall to demonstrate demand to Nintendo, and as a result I think it helped us get the allocation that we needed to meet consumer interest in the product. I think what you're seeing is that the interest has not been to the overall level that they had hoped for and that -- you know, it's not performing like the Wii did.

There are a variety of theories as to why that might be, but among them is that there hasn't been the blockbuster title from Nintendo. So Nintendo, I think, understands the need to have that first-party software available to drive Wii U sales.

Brian Karimzad: Fair enough. What about some, I guess, talk on the market-share side. I think you're kind of the rare case of a physical retailer that takes share when Amazon is factored in the numbers, there. What element of it is the cash nature of your business and the high percentage of your customers who do transact that way? Can you help us understand, kind of, the magnitude of customers who are cash-centric and ways you're looking to further leverage that as we go forward?

Rob Lloyd: Sure. And by cash-centric, you mean trades, or paying with cash?

Brian Karimzad: Paying with cash.

Rob Lloyd: I think one of the reasons we've gained share over the years is because of our buy-sell-trade program. The buy-sell-trade puts the currency in the hands of consumers that enables them to pay for their purchases without necessarily having to use a credit card. So I can't speak to what percentage of our sales are credit card relative to other retailers.

The interesting thing that we have noted is that when we sell downloadable content or add-on content to existing games that you digitally download, we actually sell a higher percentage of that using forms of payment other than credit cards. So the trade-in program helps that consumer that wants to either pay cash or use trade-ins to buy their DLC and not use a credit card.

I think part of the reason why we've gained share in the past few years is that buy-sell-trade program, but it's also very important that we've had the Power Up Rewards program in place and that we continue to work with the market -- or, with the publishers on marketing programs to help to drive the launches of their new games.

Brian Karimzad: Then on that digital DLC side, what inning would you say the publishers are on figuring out the retail component of that? It sounds like something that pretty much was discovered last -- about a year ago on the holiday with the Call of Duty ELITE, when they did that trial and, and some folks have followed. What further traction and conversations have you had on insight with that?

Rob Lloyd: I'd say we're probably second or third inning. Obviously, Activision takes the lead on downloadable content, and they were the first to have a regular series of DLC released every two to three months for their Call of Duty franchise. They were then the first to recognize that the way to really move DLC was at the time you launched the game.

When the consumer's in line at midnight waiting to get those games, we've found through special editions and other things that we can sell with the games through the years that that's when they're ready to part with more than just that $60 to get the games. So working with Activision, we've been very successful in increasing attach rates at the time of the launch of the game by launching the subscription to DLC.

In the fall of 2011, I think there were two of the major games that came out that had DLC available at the time of launch. The majority of the titles that came out in the fall of 2012 had DLC at the time of launch. So publishers are understanding that that's a great way to leverage those development dollars and to maximize DLC sales.

So I hope it's still early there. We continue to work with publishers on how to drive DLC, what offerings to develop to make it attractive to customers, and hopefully -- we believe we're going to see continued growth in that business.

Brian Karimzad: And then -- one of the things I hear is, we're walking into this new cycle with a lot less game supply than we used to. And these publishers -- you know, Activision and EA are not out there producing 50 titles a year, like they were back in the mid-2000s. How do you think that's going to change the character of this transition, and what are you thinking about in terms of opportunities to keep that attach rate reasonably high?

Rob Lloyd: Well, I can't speak to what inventory the publishers have of games for the new systems. We do hear that there's development going on. We have heard some rumors lately that maybe some games were held back for the new systems.

But I think once the innovation hits and the consumer comes back to the videogame category to buy new consoles and new games, I think you're going to see those development dollars increase again, and the supply of games will increase.

Brian Karimzad: In terms of selling those consoles, they're going to have larger storage space to begin with. The digital mechanism is probably going to be more elegant and in many forms. What have you thought to take what you learned in terms of the at-point DLC sale to perhaps translate that into a console sale along with software attached at the higher rate at the point of purchase, perhaps pre-download or other things like that?

Rob Lloyd: Well, I think that the thing that we've learned about DLC is that -- when we got into the business, we believed that in-store, there was a way to make a market for this, and that what was important to consumers was to show them what was available. And I think that we've demonstrated through the almost three years we've been doing it, now, that we've made that market bigger.

And one of the reasons that consumers want to buy DLC or digital content from GameStop is because our associates can tell them what's coming, what's available. You don't have to go out and search for it on Xbox LIVE. But there's a couple of other reasons they buy it from us, as well.

One is they get PowerUp points for doing it, and then the second is they can use their trade credits to pay for that DLC. So our expectation is that with the next console cycle, we'll see more digital offerings. And as digital delivery becomes greater and maybe moves from beyond DLC into full game content, we can make those same offerings available to our customers; and those same things, PowerUp points, in-store service, and trade-ins, will be drivers of sales of whatever the next wave of digital content is.

Brian Karimzad: Let's go back to capital allocation for a second. So, you're essentially returning 100% of your free cash as it comes in to the shareholders.

Rob Lloyd: Right.

Brian Karimzad: As we move through this transition, there's a couple ways it plays out. If it plays out the way you'd like to over the next couple years, there would be a substantial increase in the free cash flow that this business generates, again, a lot dependent on what happens to the used business as we move through this. Should we get a substantial increase in the free cash, would you consider continuing to return 100% of the free cash, as you are now, or would you just prefer to keep a steady absolute dollar amount?

Rob Lloyd: We're committed to driving shareholder return. And the way that we have found to do that over the course of the last year -- three years, or so, is aside from a handful of investments here or there, it's been to return cash to shareholders in the form of buybacks initially, and then in 2012, we added a dividend. And so now our plan is a mix of dividends and buybacks.

Unless we find an investment that we think will create greater return for our shareholders, we're committed to returning 100% of the free cash flow through dividends and buybacks.

Brian Karimzad: We have about five, ten minutes, so I'll open it for questions before I move forward. Any questions out in the audience?

Unidentified Audience Member: What percentage of your total business are classified as catalog, non-tier-1 titles?

Brian Karimzad: And just for the webcast, the question is, what percentage of your sales would you say are catalog, non-tier-1 titles?

Rob Lloyd: I don't have the breakdown between catalog and new releases, is how we refer to them internally, off the top of my head. But obviously, catalog is a substantial part of the business.

Unidentified Audience Member: Why would the console manufacturers even consider blocking a resold game?

Rob Lloyd: There's two ways to -- two constituencies that the publishers and the console makers -- remember that the console makers are also publishers -- that they have to consider. One is the retailer, like GameStop, that is moving their product through the channel. The second are the development firms that actually develop the games.

Developers have historically not liked the preowned game business because they don't participate in the revenue streams. The publisher is a little bit caught in the middle, understands that, but also understands the importance of the preowned game business to the overall ecosystem of the videogame business. And so I think that as the console makers balance those needs, they consider -- you know, is this an appropriate thing to do? Would we make more money by doing this in the future?

I think what customers have told them at this point, as I've said, is they view it as a very unfriendly thing to do and as a reason why they wouldn't buy consoles. So for that reason, we don't believe that that will happen.

Brian Karimzad: I guess I want to touch a little bit on the preowned mobile business. So, $160 million revenue is what you've last reported. Can you give us a sense, within that core PowerUp user base, and these are the people that pay most attention to you, what's your sense of the awareness level of this trade-in option among them and the level of participation that you're getting from them in the mobile trade-ins?

Rob Lloyd: The awareness level, we believe, is in the mid to high teens. So, they're aware that we're in the business of taking trades on tablets and phones and MP3 players. The penetration, or the actual participation of the PowerUp database in that program is probably low single digits.

Brian Karimzad: Okay.

Rob Lloyd: So there's a lot of room to grow there, in terms of upgrade cycles that happen in the mobile game business and getting those customers to come in, as well as there's a lot of room to grow in terms of awareness, and in the non-PowerUp customer, as well.

Brian Karimzad: All right. Help me understand what are some of the things you're going to do to grow that awareness. Actually, I'm a little surprised the awareness is that low within the PowerUp numbers. I guess it's a good thing because you have some ramp. But what are some of the tactics that you haven't rolled out yet, that you haven't tried to try to increase that awareness within that group?

Rob Lloyd: Well, in terms of an awareness after about a year and a half taking trades being in the high teens is in contrast to the videogame business, in which the awareness is around 40%, or below. So after 15, 18 years in the preowned game business, we still don't have 50% penetration or awareness that we take trades.

So overall, we consider what the marketing programs are that we could employ to get that awareness out there and to drive that with consumers.

Brian Karimzad: And how did this business behave -- you know, we had some interesting upgrade cycles at the end of the year. How did it behave versus what you were expecting, and what does that tell us about the coming year?

Rob Lloyd: Well, we went in with the expectation, as anybody who thinks about it for eight seconds, or so, would, that the upgrade cycle and the announcement of new major devices is going to drive trades. So that was behavior that we saw. When we had the iPhone 5, when we had the iPad Mini and the new version of the iPad that came out, we saw those increases in trades.

We were actually very successful in the PR around those, with hundreds of mentions in local news stories about, okay, the new iPhone 5 is here. What do you do with your old iPhone when you want to buy the new one? GameStop came up repeatedly as a place to go trade it in.

So that clearly was something that we expected would happen, and we were pleased that it did happen the way that we expected. Obviously, there are things that we can do to maximize those upgrade cycles in the future.

I think in terms of the overall business, we learned that the tablets and the MP3 players sell very well. With the subsidized telephone market in the US, there are certain parts of the US that are very foreign-tourist heavy, where we sell the phones very well.

We can enhance the sale of phones through use of prepaid mobile plans, like a NET10 type of a plan. And then, there's a very healthy bulk-sale market for the preowned phones, as well. And so, we're learning about that market and trying to maximize our contacts and the availability to move products that way.

Brian Karimzad: Is this the old situation where supply is your constraint for this business?

Rob Lloyd: It does behave in the same way that the videogame business does, and that is we can move whatever we get in trade, and so it's really driving trades that is the thing to do there.

Brian Karimzad: Then another on capital allocation. You've been quiet on the acquisition front recently. The head of your Digital Ventures group has left the company. Can you give us a sense of how comfortable you are with your portfolio as it stands, and should we read anything from that move, in terms of your, maybe, reticence to step further on acquiring non-retail-type properties, I guess is the way to put it.

Rob Lloyd: Sure. Our Digital Ventures group, headed by Chris Petrovic, was extremely successful over the course of the last three years in helping to educate us about the digital gaming community and putting us in touch with hundreds of companies that are operating in that digital gaming environment. And so you can see from what we've discussed and what we've disclosed that we made some acquisitions early on.

The cadence of our acquisitions has slowed down. One of the considerations that we've had all along is that we want to acquire things that we felt were appropriately valued, that we felt we could maximize through the adjacencies with our existing business and with the synergies that we could drive. And so, maximizing returns in the digital world has been a challenge for a lot of the investment money that has gone in there. And so, that's affected the cadence of your acquisitions.

And so, as we reached the point where we were evaluating what our cost structures needed to be going forward and what the role of the Digital Ventures team was with Chris heading it, we came to the conclusion that we would use a West Coast presence that we had been using all along, in the form of a boutique investment firm, to help to advise on a go-forward basis, and with the Digital Ventures team back in Grapevine and the use of that firm out here on the West Coast, that we'd be able to maintain that same touch and contact with the digital gaming community going forward.

Brian Karimzad: Very well. Well, with that, we're out of time. So, Rob, thank you very much for joining us.

Rob Lloyd: Thank you for having us.