GameStop Corp.

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Bill: -- and I'm the high yield retail analyst here at Bank of America Merrill Lynch. Very pleased to have Rob Lloyd the CFO of GameStop with us here this morning and with that I'm going to turn it over to Rob.

Rob Lloyd: Thank you Bill, good morning. It's a pleasure to be here today and talk a little bit about GameStop. I'll start by covering the four principal lines of business that we're in which are physical video games, digital video games, collectables and technology brands. If you look at the left of the screen there in the red, the core physical video games is of course the bread and butter that we've had for 20 plus years now. That represents about a $13 billion U.S. market. We're the market share leader in the United States and then in all of the countries in which we operate except for one and that business involves selling the consoles made by Sony, Microsoft and now Nintendo with a new Nintendo Switch and all of the software that you get from Sony, Microsoft, Nintendo, Electronic Arts, Activision, etc.

That business for us is fueled by the 55 million members that we have in our loyalty programs around the world. Years ago, we extended into the digital gaming space as digital was becoming more a part of what was going on in console gaming and in mobile gaming as well. So we sell the currency that allows you to get onto the Microsoft and Sony platforms. We sell the subscriptions for Xbox Live, PlayStation Plus, etc. As well, we sell downloadable content; both full games and add on content for recently released games.

We recognize the need to diversify the business away from just physical video games and gaming, including digital both inside and outside of the video game store base so the first thing we did was start to sell some collectables in our stores and we do that through three channels principally selling inside of the video game stores. There's a strong overlap with the video game consumer. We sell through ThinkGeek.com which we acquired a couple of years ago and we have a little over a hundred standalone collectable stores. That business will do between $650 million and $700 million this year.

Technology brands is a diversification outside of the video game store base so we operate principally inside our technology brands division, 1400 AT&T branded stores. So AT&T has about 5500 stores overall, they own and operate about 2200 and 3300 are in the hands of authorized retailers of which we're the largest at 1400 stores. We also operate about 60 Cricket stores which is AT&T's prepaid brand and about 50 Simply Mac stores. Simply Mac is essentially an Apple store for a smaller community where the population would not warrant an Apple store by itself.

So we'll talk about each of these in a little bit more depth. The goal of our diversification strategy is to go from what was in 2010 a company that was almost wholly reliant on the sale of physical gaming products for all of our profit to a business by the end of 2019 will get half of its profits coming from something other than physical games. Last year in 2016, 37% of the profits came from something other than physical games. We should be 40% to 45% this year.

Highlights from our recently announced quarter included a comp store sales increase of 1.9%. That's the third consecutive quarter of positive comps. Comps have been driven this year by hardware. Hardware is driven principally because of the launch of the switch back in March. 8.8% hardware growth in the quarter. Software picked up in the quarter as well with growth of 5.4%. The strong title lineup is typically what's going to drive software up in a particular quarter and it might be down if the software title lineup is weak. In this particular quarter, Destiny 2 was launched and that was the best selling game in the quarter.

Our collectable sales increased 26.5%, that's a high growth business for us. We'll talk more about that and our Omni channel sales increased 38.6% and we'll talk about what Omni channel means inside of the GameStop world but Omni channel this year has been driven by the switch as well.

In terms of some of the financial results, sales just under two billion with growth of 1.5% as I mentioned same store sales of 1.9%. Our gross margin declined a little bit based upon what we've seen in our technology brands sector. That impacted operating earnings as well. However, our net income grew on an adjusted basis principally because we got the benefit of some settlement and timing of discreet tax matters in the quarter and as a result we had a growth in EPS as well.

From a gross profit by category standpoint you can see there that we had a little bit of a dip in the margin rate on hardware. That's typical when you launch a console like we did the Switch they tend to start out with a single digits margin which drags that category down a little bit until the consoles age a little and we start to see some device reductions. New software grew based upon sales in the growth in sales. Our pre-owned business declined a little bit both in terms of sales dollars. I think we were down about 2% but also in terms of the margin rate and that's reflective of some promotional programs we ran during the quarter.

Video game accessories rebounded in terms of margin rate. Last year was heavily influenced by the sale of Sony's PlayStation VR when it launched. Lighter sales of headsets this year allowed that rate to climb back up a bit. Our technology brands business suffered in terms of the dollars and we'll talk more about what's going on inside of technology brands here in a minute. Our collectables business you can see grew about - little over 30% both from the growth in sales that I mentioned in 26% plus an increase in the rate during the quarter. That business generally is going to be around the 35% margin, maybe a little better, some quarters a little lighter than others.

Overall, our gross profit dollars dropped principally because of technology brands. The rate dropped a little bit as we've shifted some sales out of technology brands which you can see is our highest margin rate category into hardware and software which are our lowest margin rate categories.

In terms of the guidance for our full year, we've raised our same store sales guidance to low to mid-single digits. That's reflective of what's going on with hardware sales. Our tax rate, because of the tax items I described, should be around 31% for the year. The net income is implied by our EPS range of $3.10 to $3.40.

So inside video gaming, I mentioned it's a $13 billion U.S. market and it had been that way for many years. Declined a little bit in 2016 as we were in the fourth year of the console cycle for the PlayStation 4 and the Xbox One. It's growing again this year though again because of the switch. You can see what's happening on the hardware so far through October this year and then the software is down a little bit from last year. What's important to note here is how the Switch is doing relative to the Wii. Within the first eight months in the marketplace, Switch has done about 80% of what the Wii did. You might recall that the Wii launched in the fall so it had a holiday in its first eight months whereas we haven't seen a holiday yet for Switch but it's important to note that GameStop is up 130% from what we saw for the Wii in the first eight months. That's reflective of the market share that we've gained in the Nintendo space.

So because we are heavily reliant still on the physical video game business and it's console driven and goes in cycles according to consoles. It can go in smaller cycles according to what's going on on the game side of the business. We've had a multi-year strategy to minimize our store footprint. We have a very small percentage of stores that are unprofitable. So, for us, what we try to do is close 2% to 3% of the store base every year and we're going beyond those unprofitable stores and closing stores that actually make money.

Generally we'll look at stores that make less than $50,000 a year as candidates for closure. And what we'll do, and we'll talk more about this in a moment, is we use our PowerUp Rewards program to help us drive customers down the road to other nearby stores and we can actually make more money by closing a profitable store and leveraging the fixed cost at another store.

So as you can see, we've taken the store footprint down about 12.5% through the years. One of the ways that we do that is by keeping a really flexible lease portfolio. We've got an average remaining lease term of two years and five months, that's intentional so that if shopping demographics change, if digital were to grow faster than we anticipate, that it will - we're able to adjust to store base accordingly. Our PowerUp rewards program is really a key asset for us. It gives us the data that we need to be able to reach the customers with the offers that we know that they want based upon their buying habits, their trading habits, sending them reminders to come in and trade their games, marketing collectables products to them that go along with the intellectual property we know that they're fans of. It might be Star Wars, it could be Game of Thrones, Call of Duty, so it could be movie, TV show, video game related. But we'll use this tool to help us market and as I mentioned, we'll use it to help market to customers and let them know that their home store, which may have closed or it's about to close, they can shop at other stores nearby.

We're in about one of five U.S. households in terms of our 38 million U.S. members, 17 million members around the world. PowerUp members account for about 70% of our sales, they're three times as frequent shoppers with us and that makes us five times more profitable because they're participating in things like trading in games and buying pre-owned games as well.

We recently rolled out a new paid membership. We've had a paid tier for years, approximately seven million members in the paid tier, now with the higher level $30.00 elite member, we've got half a million members already on a program that we completed rolling out in October.

I mentioned earlier that Omni channel has had strong growth for us this year with the switch. For us, Omni channel is obviously website, it's mobile, it's web in store, it's pickup in store, ship from store, a variety of ways to allow the customer to interact with our Websites. In fact, what we see is that 25% of our Web visitors will buy in store within 48 hours. So they're shopping our site to understand what's available so when they come in they can make quicker more intelligent decisions about what they want.

60% of our transactions involve both online and a physical store. What we did with the Switch, that's important to drive this 70% growth, is the quantities were very limited for the first six months after the launch. In a given week we might have gotten roughly one per store in the U.S. It could have been up to three or four per store, that's not efficient in terms of shipping to the stores and providing a good customer experience. So by putting them onto our web and store program and then selling them through our website, what it allowed the customer to do is for those customers that were watching and acting quickly enough, they could go in any store, regardless of whether or not they had stock, place and order and have it delivered to their home within a couple of days. That was an efficient way for us to, one, meet the customer demand and minimize our shipping costs.

On the digital side of gaming, that's obviously the overhang that drags down the GameStop stock. The concern is not around what's going on with digital currency that allows people to transact online, it's not what's going on with the memberships to Xbox Live and PlayStation plus, it's not having to do with the added content that comes out shortly after a game gets launched. We do very well in each of those areas with anywhere from 25% to 40% market share.

The concern centers around the customer initially adopting a digital copy of a game instead of a physical copy of a game. So downloading it instead of buying it physically in one of our stores. According to NPD, which started tracking what's going on on the full game download side of the business a little under a year ago, about 30% of sales of games are happening digitally now which means there are 70% that are happening physically. We're the share leader on the physical side of the business so that's very important.

What we've seen in the last year and a half is that there have been a handful of titles that have launched with more than 50% of the game sales being full game downloads as opposed to physical copies. We have some share data with respect to the physical and digital mix. We know that from what we've sold physically, we know what we've sold in terms of full game downloads because we sell those as well. We're still 30% or more share for those titles that launch with a 50% or more digital penetration. So, what's important about that is in a more than 50% digital world, we're still a very relevant share player and that's important. As you look at what's going on in downloads, again, about 30% is what we're seeing.

You're going to have some titles and some publishers that will drive that higher and then you have publishers and titles that will drive that lower. Kid oriented games for example, do not download heavily. Something like a Destiny 2 does download heavily. So the nature of the game is important in this discussion.

The other thing that we've seen that we think limits the overall penetration of digital is that over 50% of the games that get sold in the United States get traded in at GameStop over the course of the year. So, that number has been growing from the high 40s in 2012 to 53% now. And that's important because what it tells us is that there's a base level of consumer that has to be able to trade in games in order to keep buying the games that they want. The $20.00 to $25.00 that we give them in residual value is important for them to fund the future purchases and we give over a billion dollars a year in credit to customers that trade with us.

So switching gears to our technology brand segment. As I mentioned earlier it's principally AT&T branded stores, Cricket branded stores and Simply Mac. Most of our discussion will focus on the AT&T branded store base. Obviously that's the largest component and that's where the growth has been.

We get paid in three ways by AT&T, principally we get paid to sell new services, upgrade customers to new phones, add additional lines and data plans etc., and we get paid commissions that range from 65% margin to 100% margin on those things in cases where you come in and you sign up for a plan and you get a free iPad, there's a cost associated with that so it's going to be less than 100% margin transaction but that's the biggest bulk of what it is that we're doing inside an AT&T store.

We've had some challenges inside our profitability this year on technology brands principally because of the commission structure that AT&T has. They have historically incented us to drive those wireless transactions, those upgrades, sales of new phones and data plans. They bought DirecTV a couple of years ago. They're trying to close the Time Warner deal, could be a challenge, but what they're doing now is they've deemphasized the sale of mobile products and wireless plans by doing that - by that I mean they've reduced the amount that we get paid per transaction. They've more than increased the dollar amount that we get paid for DirecTV. The challenge to us is that DirecTV is a small percentage of what we're selling in store.

So as AT&T becomes more of an integrated communications company, trying to drive all of these types of transactions, they've changed our compensation and while we adapt to that mix, that's been a challenge. The other component has been that everyone of the carriers in the U.S. changed from the subsidized handset sale that was going on up through 2013 to a leasing model. So every customer now knows 98% of the transactions take place using a lease. So those lease customers know how much they're paying every month for their phones. So it's become a little bit like the used car market in that you get that car paid off, you get that phone paid off, they want to use it for a while before they upgrade. So what that's done has taken the upgrade cycle on phones from what was about every two years and stretched it to about every three years. And what we're also seeing is that customers want to see innovation in the types of devices that they want to use.

So, the industry was looking pretty heavily to what happened with the launch of the iPhone in this fall for that innovation cycle and for that upgrade cycle to kick in. What we saw was a split launch with the iPhone 8's coming in September and then the iPhone X coming out in early November. The challenge for that has been the consumer that chose to wait, get a look at the iPhone X before they make a decision between the 8, the X or even maybe the 7 and then of course the X has been severely supply constrained. So it's been a challenging year for us in terms of technology brands and the combined impact of that upgrade cycle, the compensation change, and the iPhone launch has had us reduce our guidance on profit there. From - we were targeting 120 million, we've taken that down to 75 million to 90 million in operating earnings this year. Still a very healthy business, certainly not losing money but not what we had hoped for initially.

The second component of how we get paid is subscriber management fees. That's sort of the least understood of the pieces of the puzzle here and that is essentially that piece of the bill that we get paid every month based upon those customers that we've added to the AT&T network over the years. So that's like a little bit of commission every time a customer pays their bill. That's very helpful to the profit model and then lastly we do sell products at retail like cases and screen protectors and things like that.

Our collectables business has been the highest growth business for us here in the last couple of years. The market in the United States is estimated to be about $12 billion and has grown from $11 billion in 2015. We think it will be $16 billion by the end of 2019. Principally, this is the market for license merchandize associated with movies, TV shows, pop culture and video games increasingly now.

In terms of what that $12 billion consisted of, toys and games is the biggest component. One of the hottest sellers are these little things called Pop! Vinyl's which you may have seen. They're based upon characters from movies, TV shows, etc., little dolls with giant heads. Those are very highly collectable items for our customer base. Apparel is important, consumer electronics, home goods, accessories, etc.

What's important to note is there is concern when we talk to people about this category that it's a fad but what's important here is that the top 15 properties that we sell have an average age of about 37 years. Star Wars is 40 years old, believe it or not. Pokémon is over 20 years old and of course Batman, Marvel and many of those other comic characters are even older than that.

So we're going to grow this business, we grew it from $300 million in 2015 by $500 million last year to $650 million to $700 million this year on its way to a billion by the end of 2019. We'll do that with expansion of square footage dedicated to collectibles inside our video game stores. We had, as I said, a little over a hundred collectable stores growing through Omni channel and ThinkGeek.com. The exclusives that we get through our licensing expertise and manufacturing expertise so basically going out and getting the license for the Star Wars waffle maker, making those products and selling them through our channels.

And then of course the overlap with our PowerUp members, our research shows that approximately 50% of our PowerUp customers spend as much or more on collectables in a year than they do on video games which is pretty substantial. So, specifically this years growth is coming in the form of an increase in the space dedicated to collectables. We started the year with an average of about 7% or 8% of the square footage in store dedicated to collectables. That number should be about 15% as we end the year and in some cases we have store concepts that are half collectables and half video games.

We're entering into more licensing agreements with major IP holders for unique and exclusive products. W e just rolled out Pokémon centers in our stores about six weeks ago that are dedicated to the Pokémon products. Those are obviously going to be hot sellers at Christmas. Leveraging the loyalty programs and marketing collectables to the consumers that have indicated an interest in the more heaviest collectables buyers follow on average nine intellectual properties be it Star Wars, Doctor Who, etc. Our medium buyers still have about five for which they'll buy. So we can use our loyalty programs to market to them in that way.

And then most recently we added an executive that we plucked out of Walmart who's got 20 years experience in this kind of category with both Frito Lay and Walmart driving licensing products and programs. So, she's already getting us in to see the heads of studios, getting advanced looks at scripts that will enable us to develop the products that we'll be appealing to the customer base.

The last thing we'll talk a little bit about cash flow usage. About $300 million of free cash flow for the year. This years impacted by a 53rd week which probably takes about $100 million out of our typical free cash flow generation per year. We'll spend about $110 million to $120 million on capex. Our dividend has been very important to us, we pay about $150 million a year in support of the dividend. We won't have a lot of M&A this year. Principally our M&A has been around technology brands and we've tapped the breaks on that a bit given the challenges we've seen in profitability there and given the rest of the authorized retail base is seeing those same challenges, we want to make sure that the market has fully absorbed the impact to valuations before we get more active in M&A.

Share buybacks have always been an important part of what we've done and they're important to shareholders as well. With that, I will open it up for any questions that you might have.

Bill: Rob, I'll kickoff with one. Obviously the launch of the Switches has done good things this year for your hardware sales and greatly influences changes in the cycle in terms of new platform launches can be helpful. Can you talk about the outlook in terms of new platform launches, what we should expect, and then also when the profitability within a launch of a new platform usually peaks based upon when you are on allocation versus when you have a better number of units to sell.

Rob Lloyd: Sure, so what we've seen in the last couple of years inside the console space is that Microsoft and Sony have sort of learned a lesson from what's gone on in the mobile technology space and that is that you can't go multiple years without some sort of iteration of your technology. So as a result, we saw slim versions last year, PlayStation introduced what they call the Pro version which has more 4K gaming and VR gaming capability. Microsoft recently introduced what they call the Xbox One X which is 4K gaming, streaming and playback of discs, movie discs and that's now the most powerful console in the market. So that was just released about three weeks ago. It was met with very high demand but because it's brand new, as what always happens when they launch new consoles is we can never get enough to satisfy the customer. So we saw that with the Switch for six months, it was late September before we finally had enough stock on the Switch to be able to meet customer walk-in demand and we're seeing the same thing on the Xbox One X that limited availability makes it an in-demand item; both of those doing very well or expected to do very well this holiday season.

So, in the future I would think that we would see continued iterations of the products from the big makers at least Microsoft and Sony. Nintendo tends to still follow every few years, console introduction cycle but the other guys I think want to step up the technology inside their platforms rather than wait several years and have a huge leap forward in technology.

Unidentified Audience Member: Hi, a lot of discussion about retail real estate and you're a big consumer of retail real estate. You had a point about I think your average lease left 2.5 years so what's that mean, one out of every three of your stores has a lease renewal every year?

Rob Lloyd: A little more than that. This next year we have 1700 leases coming up for renewal out of our U.S. store base.

Unidentified Audience Member: So in this calendar year or in the last 12 months, what's your average rent increase, decrease, across the whole store portfolio?

Rob Lloyd: We've actually done --

Unidentified Audience Member: -- renegotiated this year?

Rob Lloyd: We don't do reasonably well in terms of holding the rent costs down. What happens when you close 2% or 3% of your stores every year is that when you threaten a landlord with, I'll close the store if I don't get either a rent reduction or keep the rent the same, they know that you'll do that. So, that has been very effective for us as a tool to work with the landlords. Of course the retail environment this year has made it a little bit easier for us to get the kind of terms that we want compared to say a 2015 or 2016 when landlords were feeling much better about the retail environment and trying to push things up.

Bill: Another question from me. With regard to the tech brand segment, the de-emphasis of the selling wireless plans and more focus on DirecTV do you believe that that segment is going to be less profitable then you previously had thought or do you believe that over time your salespeople can adjust your behaviors, maybe they're understanding and selling techniques to ultimately achieve the same profitability?

Rob Lloyd: I think it's a combination of us adapting to the sale of wire -- of DirecTV along with the wireless products. AT&T marketing, the price for which you can get DirecTV when you combine it with your unlimited data plans, I think that's important as well. But fundamentally what we've seen with compensation changes from AT&T through the 15, 16 years that our guys have been operating these businesses, is that the pendulum sort of swings on this and we're at a point where the environment is less favorable for the authorized retailers but AT&T understands that you've got to have a profitable thriving authorized retail base for them to be able to achieve the goals that they have overall for their business. They want their partners to be able to invest in their businesses. Right now it's not really an investable proposition for us. We obviously have investment in it and it's producing cash flow and profits for us but we're hesitant to commit more and AT&T doesn't want us to be hesitant to commit more, they want this to invest in it. So, we expect that there will be some change in that as well.

Bill: I'll open with another one. In terms of the collectables business, there's a huge opportunity there. You showed how big the market is, how big it can be. What percentage of your products at this point are exclusive, how do you expect that to change over the next couple of years and what are you guys investing in terms of increasing that percentage?

Rob Lloyd: Our products are probably -- it's in the teens I would say that are exclusive. And there's a couple of ways that we'll go about getting exclusives. One is through our ThinkGeek division through this new executive, Janet Baris (ph) that we hired from Walmart. Going out and developing those products and manufacturing them ourselves, the other is that we've had success in going to some of the makers that have licenses. So for example Funko which makes those Pop! Vinyl's has made exclusives for us before related to video game characters and other things. So, we work with those third parties as well to get exclusives from them so it doesn't just have to be things that we develop on our own. And we would expect that percentage of exclusives to grow.

Bill: Thank you very much. Thanks Rob.