

Game Digital

The long game

Game Digital (GMD) is a market leader in video gaming with an enviable 32% average share of its two markets. It is executing a major change of strategy aimed at a fuller, experience-based relationship with its customer group, which should bring reduced dependence on the cyclicity of the games market. For the moment management is focused on the transition, while the balance sheet, and hence the dividend yield, is well protected.

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	2.5	2.9	31.8
07/16	822.5	28.0	16.4	8.8	3.4	5.3	0.7	7.4
07/17e	812.6	17.9	5.9	2.7	2.0	17.4	0.4	4.3
07/18e	813.2	19.0	6.4	2.9	2.0	16.2	0.5	4.3

Note: *PBT and EPS (diluted) are normalised, excluding amortisation of acquired intangibles and exceptional items. FY16 is for 53 weeks.

The transition to cycle independence...

GMD's business was once a high street retailer but is now developing income streams giving independence from the traditional gaming cycle: events, esports, digital activities, accessories, and Gametronics (used smartphones/gaming devices). We forecast these to grow their share of profit, creating stability, to reach 77% of EBITDA by FY20, when they should augment the effect of the up-cycle.

...is the journey to multi-channel retail

GMD's experiential product area is suited to the progression, and its multi-channel strategy is to develop relationships with the interest group, across terrestrial stores, the website, the app, events and esports, and media content. Multichannel spend per customer is over double that for individual customers. As part of this, GMD's stores are acquiring a new identity as centres for advice, trial and social interaction, including BELONG gaming arenas. With seven million annual customers, and events attracting up to 70,000 visitors, interest may be specialist but it is not small.

Game on for change

Ironically for a business in such a fast-moving market, an investment view of GMD must look at the medium term. The issue for investors is whether the company can preserve and improve investment returns as it manages the transition. It is well positioned to do so, with a clear change programme well advanced and an active and focused management. Investors also have the assurance of net cash on the balance sheet, which we forecast rising from 23p to 36p per share over four years.

Valuation: Separating core from growth

We value the shares on three metrics: peer comparison, DCF (using a high 15% cost of capital to factor in execution risk) and sum of the parts, in which we separate out the cyclical and growth elements of the business. These give a valuation range of 88-100p with a blended valuation of 93p. This implies an FY17e P/E multiple of 34x, which is unlikely to be seen soon: the shares represent an opportunity on a medium-term view.

Initiation of coverage

Retail

19 April 2017

Price 46.25p

Market cap £79m

£1.16/€

Net cash (£m) at 28 January 2017 69

Shares in issue 170.9m

Free float 51%

Code GMD

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 11.8 (18.4) (62.2)

Rel (local) 15.1 (18.3) (66.5)

52-week high/low 124.5p 38.9p

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

August 2017 Pre-close update

October 2017 Final results

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Game Digital is a research client of Edison Investment Research Limited

Investment summary

Company description: Multichannel strategy is key

Game Digital (GMD) is a vendor of video game experiences, trading in the UK and Spain. Its product range includes software, hardware, events and playing opportunities. Currently it is the market leader with a 29% share (among retailers, including Amazon) of games hardware and software in the UK and 39% in Spain. Its strategy, while preserving that leadership, is to maintain and develop relevance to its interest group. As a retailer, GMD has some advantage as its product area is experiential, so that service, trial and participation are integral. Arguably it is a more direct path for GMD to adapt to the connected world than for retailers rooted in old-world product transactions. GMD's multichannel strategy aims to reach customers through terrestrial stores, the website, the app, esports (online sports contests), gaming events, media and community activity.

Financials: Strap in for the long haul

The first half to January 2017 saw a 30% reduction in EBITDA to £23.3m. While gross transaction value (GTV) only reduced by 0.5% (excluding lower-margin hardware), unfavourable mix factors at gross profit level (down 5.6%), together with cost increases mainly on investment in growth, caused the rest of the decline. Pre-tax profit was down 39% and the dividend reduced from 1.67p to 1p. The results suggest that for the moment the company is still over-dependent on the market cycle.

Although cautious on any H2 boost from Switch, we forecast pre-tax profit stabilising in single digits for FY17-19, as growth in cycle-independent streams counters further cyclical weakness, and growing strongly in FY20 as they reach 77% of EBITDA and the cycle also recovers. Positive cash generation throughout provides significant protection. Bank facilities are £80m (c £125m at peak).

Valuation: Highlights medium-term opportunity and risk

We value the company on three measures:

- **Peer comparison:** The world is short of direct industry comparisons, but companies serving other special interest groups also provide a valid benchmark and point to a valuation of 91p.
- **DCF:** DCF is arguably a better measure as it takes into account the medium term, which is essential to assessing the investment case. Reflecting execution risk with a high cost of capital of 15%, we value the shares at 88p.
- **Sum of the parts:** In our view, sum of the parts is the most appropriate method of valuing GMD. We value the core cyclical business as a perpetuity at 13p, and the growth business element at 87p, a total of 100p.

The three metrics combine to a blended valuation of 93p. This implies an FY17e P/E multiple of 34x, which is unlikely to be seen soon: the shares represent an opportunity on a medium-term view.

Sensitivities: Upside and downside from volatile markets

Clearly GMD's change strategy embodies significant execution risk, but the main commercial risks to valuation that we see relate to its dynamic markets. Reality may differ from forecasts that assume the next market upturn in 2019. Advances in digital technology could skew outcomes, especially if the market moves further to digitally delivered content. Product-led changes such as reaction to console releases, virtual reality or category-killer products may change behaviour, while GMD's creation of new markets such as events and esports could have a greater or lesser effect on results than we have assumed. In addition, GMD's high overhead structure means earnings are highly geared to top-line changes, though potential estate reductions could change that.

Company description: Providing gaming experiences

Game Digital (GMD) is a vendor of video game experiences. Its product range includes software, hardware, events and playing opportunities. It is the UK and Spanish market leader with a 29% retail share in the UK and 39% in Spain. Its strategy is to maintain this leadership, develop services and build new markets.

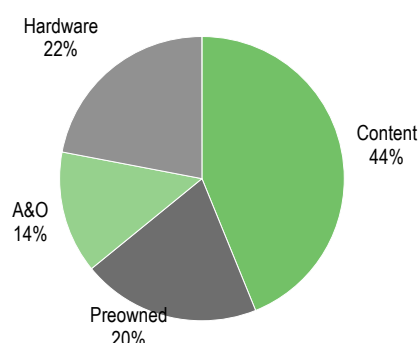
GMD was admitted to the premium segment of the LSE in June 2014 at 200p, after the predecessor business, Game Group, went into administration in 2012. Game Group had a focus on product retailing, with c 870 stores. GMD now has 581. The estate reductions were mainly in the UK, which has halved to 311. In the more stable Spanish market the estate of 270 is little changed since the addition of 44 Gamestop stores in 2014.

The prospectus highlighted certain key strengths of the reformed business. It is leader of an increasingly complex market, with a differentiated customer proposition; it has valuable customer insight and is a key partner for suppliers, with a flexible cost structure and capital-light balance sheet.

The existing business: Two classes of activities

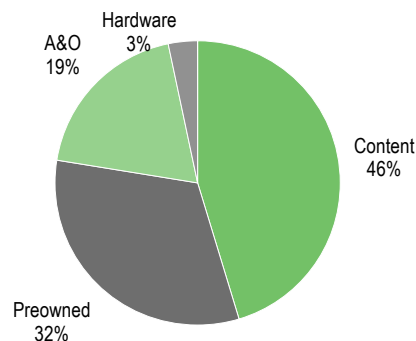
We examine below GMD's current activities, distinguishing between those that tie it to the gaming cycle and those that develop independence from the cycle.

Exhibit 1: Group GTV by category



Source: GMD, FY16 results

Exhibit 2: Group gross profit by category



Source: GMD, FY16 results

Cyclical activities

Console content: GMD retails a wide range of games content for consoles and PCs, including both physical boxed software and digital content – see www.game.co.uk. It has a c 33% share of the UK and c 45% of the Spanish retail market, worth c £0.8bn and €0.3bn, respectively. Through its close relationships with suppliers GMD is able to negotiate exclusive editions of many standard games, which include additional features of value to gamers, such as additional action sequences or in-game items, for instance vehicles and weapons.

We expect market share to reduce slightly in the next two years as more casual consumers enter the market during the latter stages of the cycle. This should reverse in FY20. While the total mix of physical to digital games sales has fallen from 78% to c 40% in the UK, we expect it to stabilise at around this level due to resistance to digital caused mainly by long download times and the inability to trade in used games. For example, physical games have resale value, typically £20 against a new price of £49. However, digital is lower margin for GMD at c 15-20% of GTV against a c 25-30% gross margin on physical games.

Hardware: Hardware is a natural product market for GMD because its high price and sophistication means that trial and service have value for customers. The total UK gaming hardware market is

c £0.5bn, of which some 60% is bricks and mortar, and GMD's share is c 30% (it is comparable in Spain). As described on page 5, it is console hardware that creates the volatility of the cycle. Exhibit 3 shows that hardware margins are low: between 3% and 7% depending on the age of the release. However, contact with hardware customers is key to GMD's penetration of the gaming market generally. Here the active interest, availability and training of store staff are clear differentiators against competition.

Preowned products: Preowned products is a significant area, ranking second in gross profit terms and c 30% of the total. The category is weighted to software, and leverages GMD's close relationship with gamers, for example making use of the mobile app to scan and trade in software. However, other than Gametronics (below) it is not a growth area for GMD, tending to track the new software market.

Cycle-independent activities

Accessories and Other: Accessories and Other (A&O) is mainly controllers, headsets and plugs, connectors and other parts collectively known as gameware. A small subset is Toys-To-Life, a set of model characters integrated into games by Activision. Growth in the category reflects the developing range and sophistication of games. It follows a smoother path than hardware or software, driven by underlying activity rather than releases. A&O includes virtual reality, currently a hot area, with sophisticated headsets in the £350-800 price range as well as mobile-driven versions retailing for as little as £30 (average spend is c £270). The future profile of VR is uncertain but the opportunity could be large.

Gametronics: Global mobile gaming was expected to be 37% of the total gaming market in 2016, growing at 16% (source: gamesindustry.biz quoting Newzoo). Gametronics represents pre-owned mobile and tablet hardware suitable for gaming. GTV grew c 60% in FY16 and growth is expected to continue as GMD represents a significant marketplace with strong supply relationships.

Esports and events: The global esports market is US\$0.7bn, growing at a 29% CAGR to 2020 (source: GMD). It is a significant strategic area for GMD (see page 7). To date contribution is small and mainly from acquired businesses: Multiplay (March 2015) and SocialNat (February 2016). GMD's events sales have grown by a 78% CAGR over the last three years. GMD is also developing its BELONG arena format, with nine trading so far.

Digital Services: With Multiplay GMD also acquired a game server hosting business, providing B2B solutions for games developers and publishers. Typically publishers have limited server capacity. In order to avoid server failure, the publisher may contract with Multiplay to provide capacity through a combination of firm purchase and a contingency element triggered instantaneously by demand. The operation is not currently significant to results, although contract signings could change that. The company also acquired Ads Reality, an augmented reality business, in May 2016.

Mix and margin

On GMD's definitions, current GTV is weighted 70:30 to core against growth activities. Growth activities as a whole earn a higher gross margin, though not if hardware is excluded from core.

Exhibit 3: Mix and gross margin: FY16

	% of GTV	Gross margin on GTV
Software	31.0%	25.8%
Preowned – Core	14.9%	41.2%
Toys-To-Life	1.9%	31.0%
Hardware	22.3%	2.9%
Core categories	70.2%	21.9%
Digital content	12.9%	17.3%
Preowned – Tech	5.9%	20.1%
Other accessories	11.1%	33.1%
Growth categories	29.8%	23.7%
Total	100.0%	22.5%

Source: GMD, Edison Investment Research

FY16 does not materially include esports, events and digital operations, which on our projections should add c 4% of GTV to growth categories by FY20, raising their gross margin by c 300bps. At EBITDA level, we calculate that non-cyclical growth categories contribute over 50% of EBITDA (see page 8), and the proportion is set to grow as esports, events and digital activities develop.

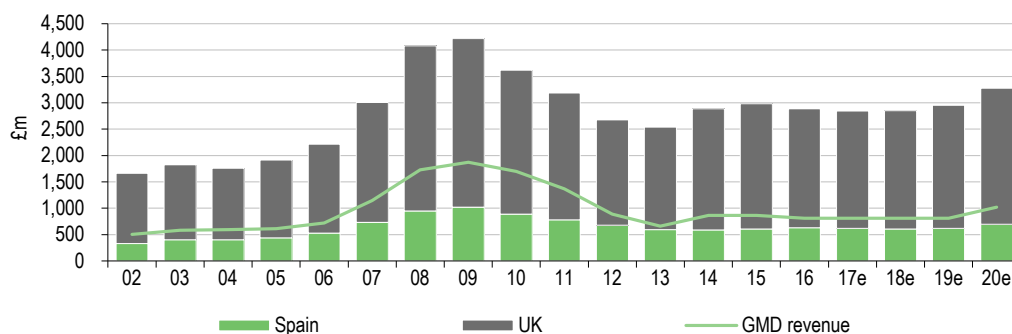
GMD in its markets: Dynamic and volatile conditions

We now examine GMD's place in the existing video games market and then its opportunities in new markets, which are fast developing in a number of areas.

The games cycle

Core content: Playstation and Xbox

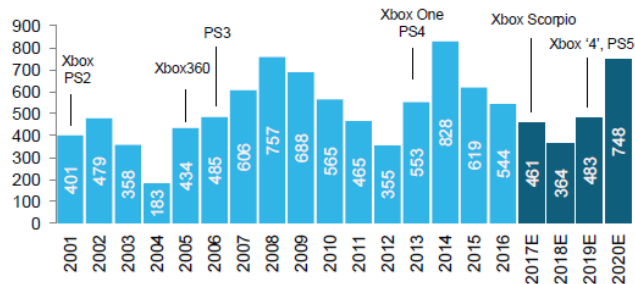
The core games market defines a cycle that is predictable in its volatility.

Exhibit 4: Riding the cycle – GMD revenue vs the UK and Spanish video games market (£m)


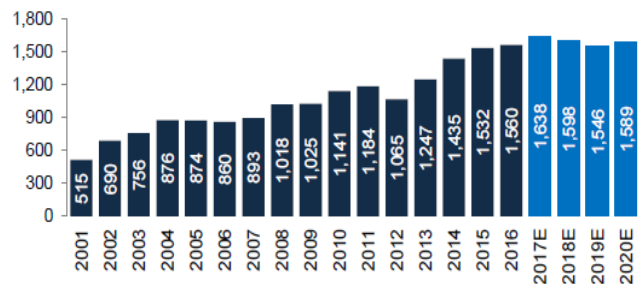
Source: GMD, Edison Investment Research forecasts

Console releases from Microsoft and Sony drive demand that has peaked every six years since 2000. Troughs occur every six to eight years in anticipation of releases. The next major event comes in 2019 with the release of PlayStation 5. In the short term, Xbox Project Scorpio, due autumn 2017, is not currently expected to have a major impact. However, Microsoft's apparent move to shorter release intervals could itself signal the beginning of structural changes to the traditional six-year market cycle, emulating the mobile and PC markets.

The content market responds to hardware releases with a build-up of activity but is a less volatile, while larger, market and therefore provides some smoothing.

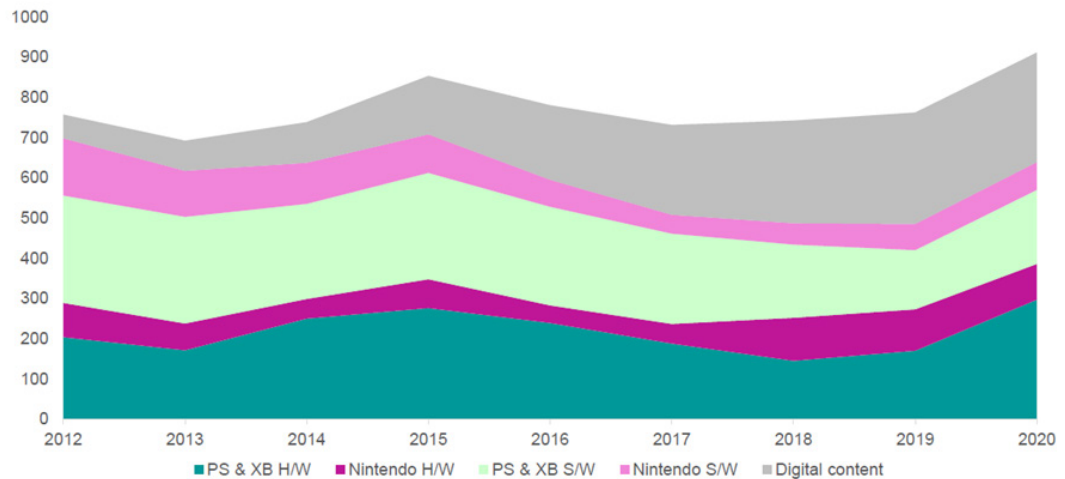
Exhibit 5 Core console cycle (£m)


Source: GMD based on market data

Exhibit 6: UK physical software & digital content (£m)


Source: GMD based on market data

The Spanish market, responsible for c 28% of GMD's revenue, is more stable, although like the UK it has become more weighted to digital content recently.

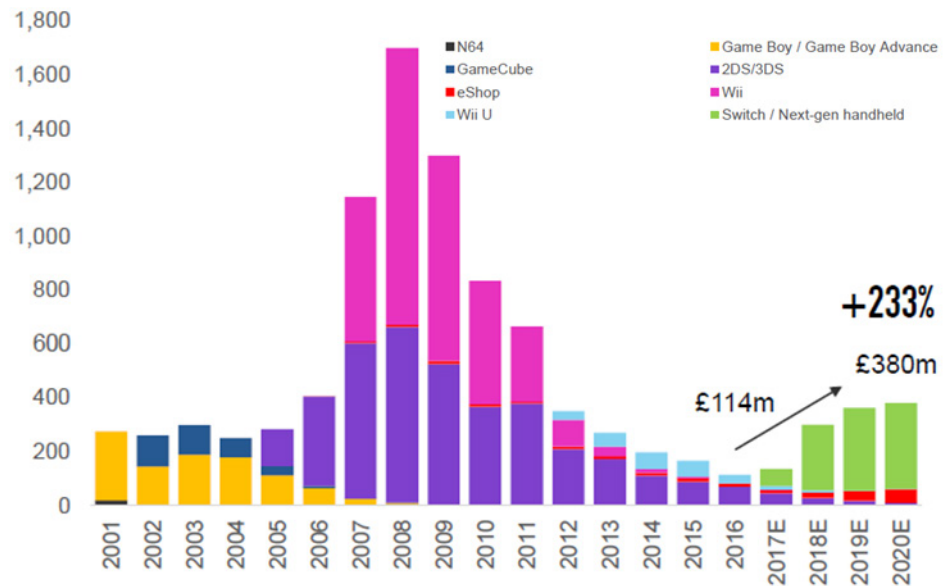
Exhibit 7: Spain – a more stable market (€m)


Source: GMD based on market data

Nintendo: Disruptive potential

With the Wii, Nintendo showed an ability to further disrupt the already irregular market. In 2008 the Wii drove c £1bn of UK sales, bringing a new class of casual gamer to the market. However, its success was not replicated by the Wii U in 2012 (Exhibit 8).

Exhibit 8: The Nintendo wildcard – UK hardware and software sales (£m)



Source: GMD based on market data

Early sales of the new model, the Switch, launched in March 2017, while below the Wii, have materially surpassed the Wii U. Overperformance here could help GMD over the next years.

Strategy: Building on market strength

GMD has an innately strong market to the extent that its product is both technological and socially driven. Its specialist product knowledge and involvement connect it to the end customer. Its task is to maintain and develop relevance to the interest group. As a retailer, GMD has the advantage of an experiential product where service, trial and participation are integral. Arguably it is a more direct path for GMD to adapt to the connected world than for retailers rooted in old-world product-only transactions.

The stated strategy puts the customer experience first. The main elements are to:

- Maximise core retail potential, to retain GMD's position as the number one destination for gamers.
- Expand live and online gaming services for gamers and publishers, including gaming and esports events and gameplay areas.
- Develop new markets through digital enterprise services, eg server hosting, digital marketing.
- Optimise efficiency while investing for the future.

The strategic journey: A multichannel retail approach

GMD's approach to retail is to exploit all channels in which it can interact with customers: terrestrial stores; website; the mobile app, events and esports; and media content. The multichannel approach is to comprehensively address customers' needs based on a fuller relationship. The average multichannel customer spends £394 pa compared with £157 for individual customers.

Terrestrial stores: The multichannel strategy calls for stores to better engage with their annual 84 million visitors, rather than being limited to product transactions. Footfall is holding at c 1.5m per week over the last five years. But GMD aims to transform its estate. It is trialling designs for different store sizes, aimed at optimising customer experience. Where possible the BELONG

concept (see below) is included. With 232 UK lease events in the next three years, GMD has significant leverage with landlords to facilitate desired changes, and could equally exit unsuitable locations, which, on the example of 2012, would be unlikely to affect market share, while reducing heavy operational leverage. On 22 leases renewed in FY16, average rent was cut by 23%, implying c £5m of potential on the £23m UK rent roll. The physical estate could reduce significantly without loss of share, as happened in 2012, and reducing cost leverage.

The website: Traffic is significant with 121 million visitors in FY16, 54 million of them from mobile devices. GTV is around 17% of total, growing modestly over the last three years, though fluctuating around game and hardware releases and retail events such as Black Friday. The site provides a shop window and order site for the full product range. Customer accounts are used to order products, while providing customer data. Additionally, the Reward Card (19m holders, 4.5m actives) accumulates loyalty points based on transactions. The site also provides links to events (see below). Free delivery is standard, with a range of options including next day and weekend delivery, and click and collect. The UK site was relaunched in October, with an increase in conversion from 1.6% to 1.7% over the next three months, indicating progress but suggesting there is more to do.

The GAME mobile app: The app has 1.5 million registered users. To join, a customer has to create a relationship with the company via the account and Reward structure. In addition, the app provides a simple way to trade in used products, which can be scanned using a mobile device. Mobile sales account for 47% of online sales (FY15: 43%).

Esports and events: Events activity is fast growing, with FY17 revenue forecast to double to £10m. The main formats are:

- **Insomnia**, a bi-annual gaming conference at the NEC, Birmingham, attracting 50,000-70,000 visitors. The main features are pro onstage esports competitions, screened competition viewings, an expo floor for new product trial, and other live events. After two years of successful history, management aims to include live music events from April 2017. GMD owns the event and banked £5m of sales in FY16, split broadly 50% ticket sales and ancillary income (food, beverage, merchandising), and 50% commercial sponsorship income and exhibitor sales.
- **Esports tournaments and third-party events:** GMD's strength is in national events ranging from studio scale live events to community activities, including tournaments like Multiplay UK Masters, centred on major games such as Counter Strike Global Offensive and League of Legends. GMD also operates events for third-party brands such as MineCon (convention for Minecraft) and Brick Live (convention for Lego).
- **BELONG**, a gaming arena format that can be built into a store, generating income predominantly from pay-to-play or competitions. It is ideal for trialling new products, which are sponsored by hardware suppliers. BELONG opens new revenue streams for food & beverage, plus sales of PCs, VR headsets and accessories. It drives new customers into the store, with one in five new to GMD. It may also be used to schedule gaming events. A BELONG refit typically costs £50,000-100,000 with a six- to 18-month payback. Nine have been opened to date with a target of 30 pa. Indications are that BELONG drives 14% increases in core console sales and doubles sales of PC gaming.
- **Media content production and in-house broadcast studio:** This generates reviews, news, interviews, social media, YouTube, and video productions that drive traffic to the website and apps, and promotes engagement with customers.
- **Nationwide local community activity**, a broader community engagement point, intended to drive brand loyalty and competitive advantage. As one example, GMD is partnered with around 30 Premiership and Championship football clubs.

In addition, GMD will be launching an online platform imminently that will allow customers to view and participate in gaming events online.

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.

Financials

FY16 results

Results for FY16 (on a 52-week basis) showed a 35% decline in EBITDA to £27.2m. Pre-tax profit was down 39% to £16.9m and the dividend was reduced from 1.67p to 1p. This was predominantly the effect of a 3.3% decline in content GTV, which represents 44% of GTV at a c 30% gross margin. Hardware sales reduced by 22%, but as these were at a margin of only 3%, the profit effect of that was muted. Both factors reflected exposure to the cycle: GMD's UK core retail GTV decline of 11% was actually favourable compared with the market, down 12%. Spain had a positive year with EBITDA improving by 7% to £11m, affected only slightly by foreign exchange rates in the year to July 2016.

2016 action plan

In January 2016 a comprehensive UK action plan was implemented to respond rapidly to the change in market dynamics. Actions included:

- Engagement with key supplier partners to increase collaboration and optimise terms.
- Review of the UK store base to optimise the medium-term footprint and identify cost savings.
- Stock management review to optimise working capital, efficiency and customer experience.
- Review of operational processes to identify efficiency gains and cost savings.
- Organisational review for growth opportunities, cost savings and operational efficiencies.

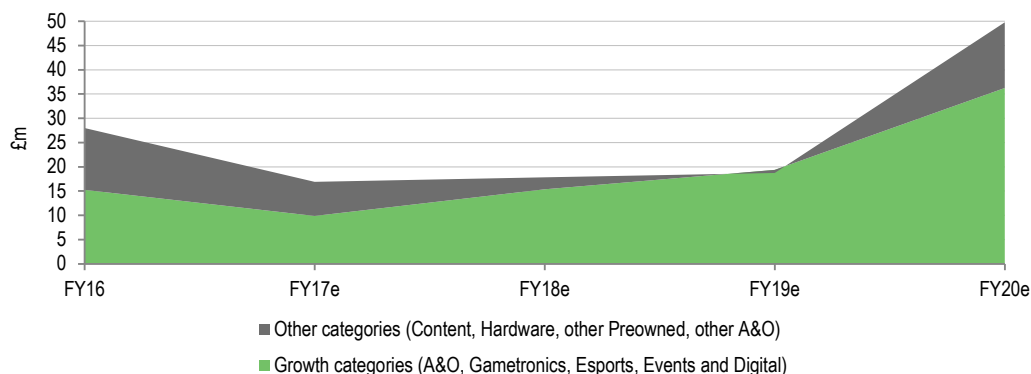
FY17 interim results

The first half to January 2017 saw a 30% reduction in EBITDA to £23.3m. Content GTV was weaker by 1.9%, and pre-owned GTV dropped 8.7% on a net reduction in older formats, while A&O increased 15.4%. Together these caused a 0.5% reduction in GTV (excluding lower-margin hardware). However, gross profit fell by 5.6%, mainly on the mix favouring newer formats in preowned, and VR in A&O, both at lower margin.

Forecasts: Jumping off the cycle

To capture the performance implications of the cycle as well as development of cycle-free income streams, we model projections of both elements from FY16 to FY20e.

Exhibit 9: Taking control – independent income streams growing to 75% of EBITDA (£m)



Source: Edison Investment Research. Note: FY16 is 52 weeks.

In this period, we expect GMD to grow its independent streams, comprising events, esports, digital activities, accessories, and Gametronics, from 56% to 77% of EBITDA (forecast EBITDA margin averages 7.7% against 0.7% for cyclical streams). This should give GMD significantly greater control over its market. We expect EBITDA of independent growth markets to weaken in FY17 mainly on initial costs of esports, events and digital, and then expand through to FY20. We have been cautious in not anticipating a specific uplift for Switch in H217 beyond that implied by previous market forecasts, despite early indications of strength, since GMD's performance here will depend crucially on stock availability.

Analysis of forecast category trends

Exhibit 10: Category actual and forecast

£m	UK						Spain						Esports, events and digital						Group					
FY	15	16*	17e	18e	19e	20e	15	16*	17e	18e	19e	20e	15	16*	17e	18e	19e	20e	15	16*	17e	18e	19e	20e
GTV																								
Content	309	286	261	249	236	284	105	116	146	142	137	138							414	402	407	391	373	423
Preowned	139	135	124	126	129	132	47	51	58	60	62	64							186	186	182	186	191	196
A&O	72	84	91	105	119	134	28	33	46	52	57	65	4	11	15	25	40	52	104	128	152	182	217	250
Hardware	208	144	119	106	82	208	50	58	63	66	66	76							258	202	182	172	148	284
Total	729	648	595	586	566	758	229	258	313	320	322	343	4	11	15	25	40	52	962	917	924	931	929	1,153
Revenue																								
Content	243	221	191	176	167	204	89	91	115	112	108	109							333	312	306	288	276	313
Preowned	137	135	124	126	129	132	46	50	58	60	62	64							183	185	182	186	191	196
A&O	66	79	82	94	107	121	26	31	41	47	51	55	4	6	15	25	40	52	96	117	138	166	199	228
Hardware	205	144	116	106	82	208	49	57	70	66	66	76							254	201	186	172	148	284
Total	652	579	513	503	486	664	211	229	284	285	288	304	4	6	15	25	40	52	867	814	813	813	814	1,020
Gross profit																								
Content	78	69	60	54	51	61	23	25	30	29	27	28							101	94	90	83	78	88
Preowned	52	47	43	43	43	44	18	20	22	23	23	24							71	67	65	66	67	68
A&O	23	29	27	30	34	38	7	9	12	13	14	15	0	1	5	9	15	19	30	40	43	52	63	72
Hardware	7	4	6	4	3	12	3	3	3	3	2	5							10	7	9	7	5	17
Total	161	149	135	132	130	154	52	56	68	68	67	71	0	1	5	9	15	19	213	207	207	209	212	244

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

Content: In response to the market cycle (Exhibit 5), we expect GTV and gross profit to decline further in FY17-19 before recovering in FY20. We expect **preowned** products to be more stable as growth in Gametronics counteracts declines in content. **A&O**, which follows a more benign growth path, should also benefit from the esports, events and digital operations, which we forecast to grow

rapidly from a low base. **Hardware** is low margin, but gross profit should be boosted in FY17 and FY20 by a mix bias to higher-margin new products.

As a result our forecast for gross profit contribution is essentially flat for FY17-19. The company moves into significant profitability in FY20 as a result of growth in independent streams (Exhibit 9) combining with cyclical recovery in the core market driven by the major hardware releases in calendar 2019. Importantly, that independence should mean future profitability becomes more sustainable.

Exhibit 11: Forecast income statement

£m	FY15	FY16*	FY16	FY17e	FY18e	FY19e	FY20e
Total revenue	866.6	813.1	822.5	812.6	813.2	813.8	1,020.2
Gross profit	213.7	207.1	209.8	207.4	208.9	212.1	244.4
% gross profit margin	24.7%	25.5%	25.5%	25.5%	25.7%	26.1%	24.0%
EBITDA – pre-exceptional	46.9	27.2	28.0	17.9	19.0	19.9	47.6
% margin	5.4%	3.3%	3.4%	2.2%	2.3%	2.4%	4.7%
Depreciation & amortisation	(8.5)	(10.5)	(10.5)	(11.0)	(12.0)	(13.1)	(15.2)
Other operating expenses	(175.3)	(179.9)	(181.8)	(189.5)	(190.0)	(192.2)	(196.8)
Operating profit (before except.)	38.4	16.7	17.5	6.9	6.9	6.8	32.4
Finance costs, net	(0.4)	(1.1)	(1.0)	(0.6)	(0.6)	(0.8)	(1.9)
Profit before tax (norm)	38.0	15.6	16.4	5.9	6.4	6.3	31.7

Source: GMD accounts, Edison Investment Research. Note: *52 weeks vs 53 weeks in FY16.

Cash flow and balance sheet

It is an important feature of our forecast that while profitability plateaus over the next three years, cash generation remains significant, preserving and further strengthening an already strong balance sheet. GMD started FY17 with net cash of £38.5m; we forecast an increase to £49.4m by July 2017. FY17 EBITDA conversion should improve from 22% in FY16, when there were significant increases in working capital, to 91%. The resulting operating cash flow of £16m is boosted by £13m of office sale and leaseback proceeds, and the total of £29m is spent on capex (£13m), dividends (£5m), and interest and tax (£1m), to leave a net inflow of £10.9m. We forecast small increases in the net cash balance over the period to FY19, and a boost from the trading upturn in FY20 to £62m. Additionally GMD has significant debt facilities of c £80m (£75m in the UK and €35m in Spain) rising to c £125m at peak periods.

Valuation

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

Peer comparison: Few close matches

The only industry peer is US operator Gamestop, whose model resembles the predecessor Game Group rather than GMD. It trades on year one and two P/E multiples of 6.7x and 6.5x, and EV/EBITDA of 3.3x and 3.2x, implying GMD values of 18p and 58p, respectively. Also appropriate (as they serve special interest groups) are UK small-caps Games Workshop, Goals Soccer Centres, Everyman Media Group and Focusrite. These trade on an average year one P/E of 19.2x, falling to 15.5x in year two, and EV/EBITDA of 10.0x and 8.8x. That implies GMD values of 48p and 124p, respectively.

Short-term multiples are not good at valuing the medium-term transition that is really the basis for investing in GMD. However, we would attach more weight to EV/EBITDA valuations than the P/E measure. With the cycle weighing on the top line, and costs burdened by investment for change, earnings after depreciation are abnormally low. Averaging the EV/EBITDA valuations above would suggest 91p. Even taking the ultra-bearish approach of excluding cash, they would indicate 68p.

DCF valuation: Valuing the medium-term strategy

DCF is an appropriate metric because it does take account of medium-term strategy, albeit this is subject to risk across a number of years. In view of that, we apply a high 15% WACC to the future streams. To represent the cycle, we assume the next three years' revenue growth beyond our 2020 forecast is the same as the average for the previous five (4.7%) before fading to a terminal 2% over the final three years. We assume no change in the 2020 EBITDA margin, and we conservatively reflect capex at 2% of revenue. On this basis we value the shares at 88p. That is c 10p sensitive to a 1% change in WACC and c 20p sensitive to a 1% change in the margin assumption.

Sum of the parts: Focus on the growth element

Since GMD is on a path to realise a business independent of the zero-sum-gain cycle, our preferred measure is to create a valuation of each element. We define the growth element as in Exhibit 9 above. Below forecast gross profit level, we model specific operating costs in esports, events and digital, and BELONG operating costs. We then allocate operating costs pro-rata to revenue, which is slightly unfair to the growth businesses, which therefore pick up a higher share.

Exhibit 12: Forecast EBITDA – growth and core businesses					
£m	FY16*	FY17e	FY18e	FY19e	FY20e
Growth categories**	15.3	10.1	15.7	20.8	36.6
Other categories	11.9	7.8	3.3	-0.8	11.0
Total	27.2	17.9	19.0	19.9	47.6

Source: Edison Investment Research. Note: *52 weeks. **As defined in Exhibit 9.

For non-growth operations, we reproduce the cycle by averaging the last five years' EBITDA of core operations, and, after capex and tax, value it as a perpetuity assuming 2% growth, at 13p per share. In the case of growth businesses, we conservatively fade revenue growth from its 2020 rate of 15.5% to terminal growth of 2%, producing a DCF valuation of 87p. The sum of the two is 100p.

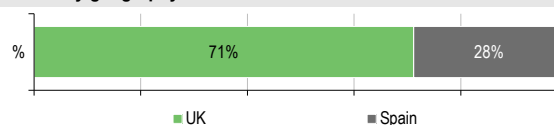
Averaging all three metrics, we define a blended valuation of 93p.

Exhibit 13: Financial summary

Accounts: IFRS; year-end: July; £m	2015	2016*	2017e	2018e	2019e	2020e
Profit and loss statement						
Total revenues	866.6	822.5	812.6	813.2	813.8	1,020.2
Cost of sales	(652.9)	(612.7)	(605.2)	(604.3)	(601.7)	(775.7)
Gross profit	213.7	209.8	207.4	208.9	212.1	244.4
Exceptionals and adjustments	(12.2)	(11.5)	(4.7)	(9.1)	(9.1)	(9.1)
Depreciation and amortisation	(8.5)	(10.5)	(11.0)	(12.0)	(13.1)	(15.2)
Reported EBIT	29.9	8.4	(2.2)	(2.2)	(2.3)	23.3
Finance income/(expense)	(0.4)	(1.1)	(1.0)	(0.6)	(0.6)	(0.8)
Other income/(expense)	(3.7)	(2.4)	4.4	0.0	0.0	0.0
Reported PBT	29.5	7.3	(3.2)	(2.7)	(2.8)	22.6
Income tax expense (includes exceptionals)	(4.4)	(1.3)	(1.2)	(1.4)	(1.4)	(7.0)
Reported net income	25.1	6.0	(4.4)	(4.1)	(4.2)	15.6
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	(0.6)	(3.2)	(3.3)	5.0
Dividend per share (p)	14.7	3.4	2.0	2.0	3.7	4.0
Adjusted EBITDA	46.9	28.0	17.9	19.0	19.9	47.6
Adjusted EBIT	38.4	17.5	6.9	6.9	6.8	32.4
Adjusted PBT	38.0	16.4	5.9	6.4	6.3	31.7
Adjusted diluted EPS (p)	18.5	8.8	2.7	2.9	2.8	14.2
Balance sheet						
Property, plant and equipment	19.2	16.8	23.4	32.4	40.5	46.8
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	68.6	63.9	58.3	50.9
Cash and equivalents	63.1	48.8	59.7	60.0	59.5	72.6
Inventories	66.8	76.1	76.0	75.9	75.6	97.4
Trade and other receivables	17.8	20.4	20.4	20.4	20.4	25.6
Other current assets	0.9	0.7	0.7	0.7	0.7	0.7
Total current assets	148.6	146.0	156.8	157.0	156.2	196.3
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	85.8	85.7	85.3	110.0
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	94.3	94.2	93.8	118.5
Equity attributable to company	126.2	126.9	124.6	118.1	109.8	115.9
Cash flow statement						
Cash from operations (CFO)	44.1	6.2	16.3	18.9	19.9	34.1
Capex	(11.3)	(13.3)	(13.0)	(16.3)	(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)	0.3	(16.3)	(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)	(2.3)	(3.7)	(4.2)
Cash from financing activities (CFF)	(39.3)	(12.4)	(5.7)	(2.3)	(3.7)	(4.2)
Increase/(decrease) in cash and equivalents	(19.1)	(21.0)	10.9	0.3	(0.5)	13.0
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	54.0	54.3	53.8	66.9
Net (debt) cash	63.0	38.5	49.4	49.7	49.2	62.3
Movement in net (debt) cash over period	63.0	(24.5)	10.9	0.3	(0.5)	13.0
Source: GMD accounts, Edison Investment Research. Note: *53 weeks.						

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Revenue by geography

Management team
CEO: Martyn Gibbs

Martyn Gibbs was appointed to the board on 15 May 2014, having been chief executive officer of Game Retail Limited since April 2012. Martyn has 25 years of experience in the retail sector and 20 years of experience within the video games industry. Martyn's previous roles include managing director of The GAME Group Plc for the UK, Eire, Scandinavia and the Czech Republic from 2010 to 2011, customer and brand director of The GAME Group Plc from 2009 to 2010, managing director of Gamestation from 2007 to 2009, commercial director of Gamestation from 2003 to 2007, head of games of HMV for UK and Eire from 2000 to 2003 and various store management, central operations, marketing and buying roles at WHSmith from 1989 to 2000.

CFO: Mark Gifford

Mark Gifford was appointed to the board on 1 October 2015. Mark has over 20 years of experience in the retail and consumer sector. Mark's previous role was chief financial officer of House of Fraser Group Limited. Mark worked at House of Fraser from 2002 to 2015, having joined the company as director of finance before being appointed chief financial officer in 2007. Prior to this, Mark served in several senior finance roles at First Choice Holidays from 1994 to 2002, including finance director – First Choice Retail. Mark also worked at KPMG between 1990 and 1994 where he became an audit manager. Mark is a member of the Institute of Chartered Accountants in England and Wales.

Chairman: John Jackson

John Jackson joined the board on 16 May 2014. He is also non-executive director for Wilkinson Hardware Stores Limited and non-executive chairman for the Rick Stein Group. John's previous roles include group chief executive of Jamie Oliver Holdings Limited from 2007 to 2015, group retail & leisure director of Virgin Group Limited from 1998 to 2007, group chief executive of Semara plc from 1994 to 1998, managing director of The Body Shop International plc from 1988 to 1993, managing director of Chesebrough-Pond's Limited from 1982 to 1986, managing director of Bristol-Myers Pharmaceuticals Limited from 1979 to 1982 and group finance director of Bristol-Myers Limited from 1972 to 1979. John is chairman of the Nomination Committee.

Principal shareholders

	(%)
Elliott Management	43.0
Woodford Investment Management	19.5
Invesco Perpetual	14.0
Majedie Asset Management	4.1
Schroder Investment Management	3.8
Pelham Capital Management	3.8
M&G Investment Management	1.9
Legal & General Investment Management	1.3

Companies named in this report

Microsoft Corp. (MSFT), Sony Corp. (SNE), Nintendo Co.(NTDOY), Games Workshop (GAW.L), Goals Soccer Centres (GOAL.L), Everyman Media Group (EMAN.L), Focusrite (TUNE.L).

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