EDISON

Game Digital

Pressures countered: BELONG moves ahead

Pre-close update

Retail

Game Digital (GMD) has finished its year with cost measures countering trading pressures and with BELONG moving into action as the first, larger, sites open. The clearer future represented by BELONG is not reflected in the share price, which remains less than cash.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV/EBITDA (x)	Yield (%)
07/16	821.9	26.4	14.8	10.7	3.4	2.6	0.4	12.1
07/17	782.9	8.0	(4.3)	(3.7)	1.0	N/A	N/A	3.6
07/18e	780.0	10.1	(3.6)	(4.1)	0.0	N/A	N/A	N/A
07/19e	778.8	13.2	(1.3)	(2.1)	0.0	N/A	N/A	N/A

Note: *PBT, EPS normalised to exclude amortisation of acquired intangibles, exceptionals.

This note summarises the Trading and Business Update at 21 August. We expect to release a longer note shortly, commenting on the business and strategy in detail.

Trading pressure countered by cost actions

FY18 gross transaction value (GTV) grew 1.8% after a 1.6% decline in H2. H1 trends continued in H2, with strong sales of lower-margin digital and hardware and challenges in pre-owned, all affecting the gross profit rate. New content launches have traded positively. GMD has countered with cost savings, particularly on lease events where it is in a strong negotiating position. Head office and distribution functions have been reorganised and contracts renegotiated as they expire.

BELONG moves into build phase

Following the February 2018 collaboration agreement with Sports Direct detailed planning has been completed. The first arena under the agreement opened in Westfield Stratford on 17 August 2018; the second is due to open in September. Both are significantly larger than the average of 19 desks in earlier openings. Further capacity has been added to current arenas to facilitate greater utilisation.

Cash and balance sheet: Increased strength

GMD is focusing on working capital and cash control, and including the November 2017 disposal proceeds of Multiplay, July 2018 cash less overdrafts were c £58m, equivalent to net cash of c £56.1m (FY17: £42.6m). Including its SPD facilities, GMD has total facilities of up to £130m, seasonally increasing to up to £169m to facilitate significant new releases and peak trading.

Forecasts: We trim our EBITDA expectation

In view of the trading pressures above, we are trimming our EBITDA forecast for FY18 by 7% to £10.1m and for FY19 by 13% to £13.2m, which also reflects initial inertia factors on the roll-out of BELONG.

Valuation: Trading sub cash – BELONG not valued

Our valuation of GMD's shares is 74p. We note the market valuation is less than net cash of £56.1m (32p) and BELONG has significant value in our view, which, like the existing business, is not valued by the market.

21 August 2018

Price	**28p**
Market cap	**£48m**

Net cash (£m) (net of finance leases) at 29 July 2018.	56.1
Shares in issue	172.9m
Free float	73%
Code	GMD
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(15.7)	(23.8)	16.7
Rel (local)	(14.7)	(21.5)	13.8
52-week high/low		61.5p	24p

Business description

Game Digital is the leading omni-channel specialist retailer of video games in the UK and Spain, with 275 stores in the UK, 268 stores in Spain and over 30% market share.

Next events

Final results	November 2018

Analysts

Paul Hickman +44 (0)20 3681 2501

Neil Shah +44 (0)20 3077 5715

consumer@edisongroup.com

Edison profile page

Game Digital is a research client of Edison Investment Research Limited

Pre-close at August 2018: Mix challenge continues

GMD reports full-year GTV growth of 1.8% after a 1.6% decline in H2. Reported revenue is indicated marginally lower y-o-y at c £780m. We set out below our analysis by region and by period, breaking out events, e-sports and digital from UK core retail based on our forecasts:

Exhibit 1: GTV and revenue trends, H1 and H2

£m	H117	H217	FY17	H118	H218e	FY18e	+/- H118	+/- H218e	+/- FY18e
GTV									
Core retail UK	366.7	195.3	562.0	365.5	190.4	555.9	-0.3%	-2.5%	-1.1%
Core retail Spain	191.0	124.8	315.8	212.4	125.5	337.9	11.2%	0.6%	7.0%
Core retail total	557.7	320.1	877.8	577.9	315.9	893.8	3.6%	-1.3%	1.8%
Events, e-sports and digital	7.7	5.5	13.2	8.9	4.5	13.4	15.6%	-17.8%	1.7%
Total GTV	565.4	325.6	891.0	586.8	320.4	907.2	3.8%	-1.6%	1.8%
Revenue									
Core retail UK	320.2	171.1	491.3	320.0	151.7	471.7	-0.1%	-11.3%	-4.0%
Core retail Spain	170.2	108.2	278.4	188.5	106.4	294.9	10.8%	-1.7%	5.9%
Core retail Total	490.4	279.3	769.7	508.5	258.1	766.6	3.7%	-7.6%	-0.4%
Events, e-sports and digital	7.7	5.5	13.2	8.9	4.5	13.4	15.6%	-17.8%	1.7%
Total revenue	498.1	284.8	782.9	517.4	262.6	780.0	3.9%	-7.8%	-0.4%

Source: GMD, Edison Investment Research. Note: Events, e-sports and digital forecasts are Edison's and are broken out of UK total.

GMD states that the trends of H1 continued in H2, with strong sales of lower-margin digital and hardware categories and continued challenges in pre-owned product that affected gross profit on a mix basis. However, where quality new releases have launched, such as God of War III, volumes have been positive. It is apparent from the above that the trends intensified in H2, taking core retail GTV from growth of 3.6% in H1 to a decline of 1.3%, with a more pronounced effect on statutory revenue indicating this effect was heavily influenced by digital. Within this, the difference between the downturn in GTV and revenue is much greater in the UK, suggesting the influence of digital was greater here than in Spain.

GMD continues to deliver cost savings in the UK to mitigate challenges in its core console market. In particular, significant progress has been made on UK cost reductions related to retail leases. The weakness of the UK property market has been well publicised, and the fact that a large proportion of the stores have current or short-term lease events – at interim, 233 of its 304 UK stores had a lease expiry by December 2018 – places the company in an even stronger position to negotiate with landlords. Management signals further cost savings resulting from a reorganisation of the head office and distribution functions in H2 and a renegotiation of contracts.

The cost-reduction programme continues into FY19 to realise further savings and efficiencies.

Digital and the Fortnite effect

We believe it is possible the significant bias to digital that has built up this year reflects the popularity of Fortnite Battle Royale, a digitally downloaded game that is free to play with paid add-ons. Launched in September 2017, Fortnite is a combat and survival game that already has 125 million registered users (source: techradar.com). It has become a worldwide craze amongst school-age children and has led to a number of concerned articles in the UK broadsheet press, with reports of children becoming addicted. GMD has not quantified changes in sales by category, but it is clear the trends of H1 have continued. It is also unclear to what extent the market changes that GMD has seen in FY18 are likely to remain more permanently or whether the prior position will reassert itself. For the moment we have assumed the latter when forecasting FY19, treating the Fortnite phenomenon as a craze along the lines of Pokemon Go that will be essentially temporary.

Cash and balance sheet: Increased strength

GMD has focused on controlled working capital and cash and indicates July 2018 cash net of overdrafts of c £58m (2017: £47.2m). Net of finance leases, net cash would be c £56.1m (2017: £42.6m). The increase in cash includes the consideration for the sale of Multiplay in November 2017, which we estimate to be in the region of £15m less a negative working capital adjustment.

Progress on BELONG: First sites open

As is to be expected, GMD's update on strategy is entirely concerned with BELONG. Following signing the agreement with SPD in February 2018, a significant amount of detailed planning has been done. The first arena under the agreement opened in Westfield Stratford on 17 August 2018, and the second at Lakeside Thurrock is set to open in September. At 50+ and 24 gaming desks respectively, these are significantly larger than the current average of 19 desks in the 19 locations opened by H1. They follow the more recent, larger openings of 24–36 desks and reflect the finding that larger sites produce steeply enhanced investment returns. We understand that capacity has also been increased at the current arenas to facilitate greater utilisation.

Earnings forecast: We trim forecast EBITDA

GMD's trading statement indicates the mix-led pressure on margins from increases in digital content and in hardware and declines on pre-owned products has continued and indeed intensified in the second half. However, these have been mitigated in part by strength in sales related to console content releases and by cost savings. We are trimming our FY18 EBITDA forecast by 7% to £10.1m, with our pre-tax forecast also reflecting increased depreciation. Our revised EPS forecast also reflects a higher tax charge relating to non-offsettable profits of the Spanish operation and one-off tax items:

Exhibit 2: Change in forecasts

£m	GTV			Revenue			EBITDA			PBT			EPS		
	From	To	+/-	From	To	+/-	From	To	+/-	From	To	+/-	From	To	+/-
7/18	925.2	907.2	-1.9%	821.0	780.0	-5.0%	10.8	10.1	-6.5%	(1.4)	(3.6)	N/A	(0.6)	(4.1)	N/A
7/19	958.2	903.4	-5.7%	840.8	778.8	-7.4%	15.1	13.2	-12.6%	0.8	(1.3)	N/A	0.4	(2.1)	N/A
7/20	1015.8	936.8	-7.8%	899.0	811.1	-9.8%	25.1	18.3	-26.9%	7.1	0.1	N/A	3.2	(1.3)	N/A
Absolute change FY18			(18.0)			(41.0)			(0.7)			(2.2)			(3.5)
Absolute change FY19			(54.8)			(62.0)			(1.9)			(2.2)			(2.5)
Absolute change FY20			(79.0)			(87.9)			(6.8)			(7.1)			(4.5)

Source: Edison Investment Research

For FY19 we similarly trim our EBITDA estimate by 13% to £13.2m, reflecting similar factors and the knock-on effect of the initial inertia in BELONG associated with the detailed planning process discussed above. Again, we reflect assumed Spanish tax in forecast EPS.

For FY20 we reduce our EBITDA forecast by 27%, bringing it more in line with other market forecasts. It still represents year-on-year growth of 38%. We base this on updated market forecasts with a flatter progression, particularly for content.

Cash flow: Investment phase will not have large net impact

While market forecasts have flattened, GMD continues to focus on working capital control and cost savings. Despite BELONG moving into investment phase, we forecast FY19 capital expenditure to remain close to our current year forecast of £17.6m, as spend is redirected to the BELONG project. These elements should counter any significant effect on the cash flow position: we forecast net change of only £3m in FY19.

Balance sheet: Very adequately protected

We forecast net cash of £56.1m to change only slightly in FY19 to £53.1m. As this will be net of around £10m of BELONG expenditure, which will be financed under the SDL facility, gross cash should increase to £64m, we forecast.

GMD retains total facilities of £130m, which potentially increase to £169m in peak periods. These comprise:

- UK asset-backed revolving loan facilities with two institutions totalling up to £50m. These can be increased by up to £25m in peak periods.
- A financing agreement to January 2020 with a syndicate of Spanish banks totalling €28m (£25m). This can be increased by up to €16m (£14m) in peak periods.
- The £55m SDL facility agreed in February comprising capital expenditure and working capital facilities of £35m and £20m respectively. Capital drawdowns are repayable over five years beginning two years after initial drawdown.

Valuation

Our current valuation of GMD's shares is 74p. We note that:

- Market valuation is less than net cash.

At a share price of 28p, the market capitalisation of £48m is 11% less than year-end net cash of £56.1m.

- BELONG has significant value in our view.

In our March 2018 note The (BE)long game, we indicatively valued the BELONG project at £31m or 18p per share.

Exhibit 3: Financial summary

Accounts: IFRS, Yr end: July, GBP: Millions	2015	2016	2017	2018e	2019e	2020e
Profit and Loss statement						
Total revenues	866.6	821.9	782.9	780.0	778.8	811.1
Cost of sales	(652.9)	(612.7)	(577.8)	(583.2)	(577.3)	(601.7)
Gross profit	213.7	209.2	205.1	196.8	201.5	209.4
Other income/(expense)	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals and adjustments	(12.2)	(12.9)	(5.7)	(3.6)	(9.6)	(9.6)
Depreciation and amortisation	(8.5)	(10.5)	(11.0)	(12.9)	(13.5)	(16.5)
Reported EBIT	26.2	3.0	(8.7)	(6.3)	(10.0)	(7.7)
Finance income/(expense)	(0.4)	(1.1)	(1.3)	(0.8)	(1.0)	(1.8)
Exceptionals and adjustments	(3.7)	(3.8)	3.9	6.0	0.0	0.0
Reported PBT	25.8	1.9	(10.0)	(7.2)	(10.9)	(9.5)
Income tax expense (includes exceptionals)	(4.4)	1.3	(2.1)	(3.7)	(2.4)	(2.3)
Reported net income	21.4	3.2	(12.1)	(10.8)	(13.4)	(11.9)
Basic average number of shares, m	168.3	168.9	169.7	172.9	172.9	172.9
Basic EPS, p	12.7	1.9	(7.1)	(6.3)	(7.7)	(6.9)
Dividend per share, p	14.7	3.4	1.0	0.0	0.0	4.0
Adjusted EBITDA	46.9	26.4	8.0	10.1	13.2	18.3
Adjusted EBIT	38.4	15.9	(3.0)	(2.7)	(0.4)	1.9
Adjusted PBT	38.0	14.8	(4.3)	(3.6)	(1.3)	0.1
Adjusted diluted EPS, p	18.5	10.7	(3.7)	(4.1)	(2.1)	(1.3)
Balance sheet						
Property, plant and equipment	19.2	16.8	17.2	17.1	20.6	21.3
Goodwill	0.0	0.0	0.0	0.0	0.0	0.0
Intangible assets	61.0	56.7	47.5	29.3	15.6	1.9
Other non-current assets	0.2	2.2	2.5	2.5	2.5	2.5
Total non-current assets	80.4	75.7	67.2	48.9	38.7	25.7
Cash and equivalents	63.1	48.8	47.2	58.0	64.4	73.9
Inventories	66.8	76.1	81.2	79.2	78.4	81.8
Trade and other receivables	17.8	20.4	23.5	21.3	21.2	22.1
Other current assets	0.9	8.8	1.7	3.6	1.7	1.7
Total current assets	148.6	154.1	153.6	162.1	165.8	179.4
Non-current loans and borrowings	0.1	3.1	2.6	1.9	11.3	21.4
Other non-current liabilities	5.7	4.4	2.8	2.8	2.8	2.8
Total non-current liabilities	5.8	7.5	5.4	4.7	14.1	24.2
Trade and other payables	93.8	90.7	101.6	102.6	99.9	104.2
Current loans and borrowings	0.0	7.2	2.0	0.0	0.0	0.0
Other current liabilities	3.2	1.3	2.6	3.7	3.7	3.7
Total current liabilities	97.0	99.2	106.2	106.2	103.6	107.8
Equity attributable to company	126.2	123.1	109.2	100.1	86.9	73.2
Cashflow statement						
Cash from operations (CFO)	44.1	3.2	9.1	13.6	11.3	18.3
Capex	(11.3)	(13.3)	(11.6)	(14.4)	(17.0)	(17.2)
Acquisitions & disposals net	(12.4)	(1.5)	13.3	12.5	1.9	0.0
Other investing activities	(0.2)	0.0	0.0	0.0	0.0	0.0
Cash used in investing activities (CFIA)	(23.9)	(14.8)	1.7	(1.9)	(15.1)	(17.2)
Net proceeds from issue of shares	0.0	0.0	0.0	0.0	0.0	0.0
Movements in debt	(1.5)	1.5	0.0	0.0	0.0	0.0
Other financing activities	(37.8)	(13.9)	(4.3)	(0.8)	(1.0)	(1.8)
Cash from financing activities (CFF)	(39.3)	(12.4)	(4.3)	(0.8)	(1.0)	(1.8)
Increase/(decrease) in cash and equivalents	(19.1)	(24.0)	6.5	10.8	(4.9)	(0.7)
Currency translation differences and other	(3.1)	1.0	0.6	0.0	0.0	0.0
Cash and equivalents at end of period	63.1	40.1	47.2	58.0	53.2	52.5
Net (debt) cash	63.0	38.5	42.6	56.1	53.2	52.5
Movement in net (debt) cash over period	63.0	(24.5)	4.1	13.5	(3.0)	(0.7)

Source: Company data, Edison Investment Research

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia