EDISON

Game Digital

Pre-close, BELONG status

Part of the retail answer

Retail

Even as Game Digital (GMD) faces short-term trading pressure, its developing BELONG gaming arena concept is arguably part of the answer of what to do with the UK's high streets and shopping centres. The first BELONG sites under the February 2018 agreement with Sports Direct are now opening. With GMD's share price still less than net cash of 32p, neither the existing business, which currently contributes £10m of EBITDA, nor BELONG which we value at 23p, are attributed any value by the market. Our total valuation is 75p.

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	2.7	0.4	11.8
07/17	782.9	8.0	(4.3)	(3.7)	1.0	N/A	N/A	3.5
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.

Strategy focuses on BELONG

The original change strategy at IPO in 2014 has coalesced around the roll-out of the BELONG gaming arena concept. Two years' trial in 19 locations has shown that arenas beyond a critical size have strong returns, and the concept fits with shareholder Sports Direct's "elevation strategy", which includes other experiential concepts such as gyms in large-scale retail formats. The February 2018 collaboration agreement formalises and funds that strategy, and the first resulting sites are now opening. We now model BELONG in detail to achieve EBITDA of £22m by FY22, with 4,079 playing stations in 126 locations (GMD's target is 5,000).

Market headwinds in context

GMD's change in strategy was always designed to counter the threat from declining terrestrial retailing of games products. FY18 has seen an accelerating shift towards digital content. In H1 gross margin (as a percentage of gross transaction value) slipped 150bp, mitigated by £5m cost savings. In H2 the mix trends have intensified. We believe that may be, in part, a by-product of the current Fortnite craze disrupting the market globally, and to that extent be temporary. Savings progress has continued in all areas, with opportunities from a large number of short-term lease expiries. Following the August 2018 pre-close we trimmed our FY18e EBITDA by 7%, and FY19e by 13%, which also reflects initial inertia around the collaboration agreement.

Valuation: Significant upside on all metrics

GMD trades at a discount to its net cash of 32p per share. We value the shares on three metrics: peer comparison, DCF and sum of the parts (SOTP). Our peer valuation of 93p is an average between US operator GameStop, whose valuation points to a GMD value of 59p, and UK special interest operators, indicating 126p. Our DCF valuation using a high 15% WACC is 61p. Our SOTP metric adds the BELONG roll-out valued as a project, net cash and the existing business conservatively treated as a perpetuity at 30%, totalling 71p. Our blended valuation between these three metrics is 75p (previously 74p). However, we note that our SOTP indicates that BELONG and cash alone are worth 55p per share.

11 September 2018

Price	**28.80p**
Market cap	**£50m**
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	(3.7)	(20.0)	(28.0)
Rel (local)	0.8	(15.8)	(27.6)
52-week high/low		61.5p	24.0p

Business description

Game Digital is the leading omni-channel specialist retailer of video games in the UK and Spain, with 277 stores in the UK, 265 stores in Spain and over 30% market share.

Next events

Final results	November 2018

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Edison profile page

Game Digital is a research client of Edison Investment Research Limited

Investment summary

Company description: Strategy moving to experiential product

Game Digital (GMD) is a multi-channel retailer in the video games market. Its product range includes playing experiences and events as well as hardware and content. It is the UK and Spanish leader in the new console market with a 26% and 38% share respectively. Its strategy is to move from lower-margin product retailing towards high-margin gaming experiences. Since February 2018 it is using its BELONG concept to drive this strategy under a collaboration agreement with major shareholder Sports Direct (SPD).

Financials: Challenges, actions and progress

Interim results showed a cyclical decline with EBITDA down 9% year-on-year. Gross transaction value (GTV) grew by 3.8% with a heavy bias towards hardware, up 24.7% against content up 1.2%. Gross profit slipped 150bp on that mix, while cost savings mitigated the decline. At pre-close, full-year GTV growth was 1.8% after a 1.6% decline in H2. The trends of H1 had intensified in H2, with strong sales of lower-margin digital and hardware categories, and continued challenges in pre-owned product. However, where quality new releases were launched, volumes were positive. Progress on BELONG continues with first opening under the collaboration agreement, with another due imminently following some initial inertia around the agreement itself. The business is now seeking far larger properties to facilitate peak utilisation. GMD continues to deliver cost savings to mitigate market challenges. In particular, significant progress has been made on UK costs related to retail leases, where there is a large number of short-term expiries. Following the August 2018 pre-close we trimmed our EBITDA forecasts by 7% in FY18 and 13% in FY19. The latter also reflects knock-on from the initial inertia on BELONG, and we are also slightly more cautious in forecasting content and pre-owned sales.

Sensitivities: Change strategy not without risk

GMD has significant execution risk around its change strategy. In particular, the agreement with SPD by definition increases dependence on another company, and SPD's recent House of Fraser acquisition, while positive in the medium term, could overlay further short-term complexity; however, it provides potential space opportunity. GMD's market is fast-changing and outcomes could differ from market projections to which we refer. Technical developments could be unexpected and product-led changes could cause unpredicted market behaviour. The company's development of new markets such as events, e-sports and BELONG could have a greater or lesser effect on results than we assume. Operating leverage is high, so earnings may be volatile, although management's continued focus on and demonstration of significant savings to date indicates the ability to mitigate that.

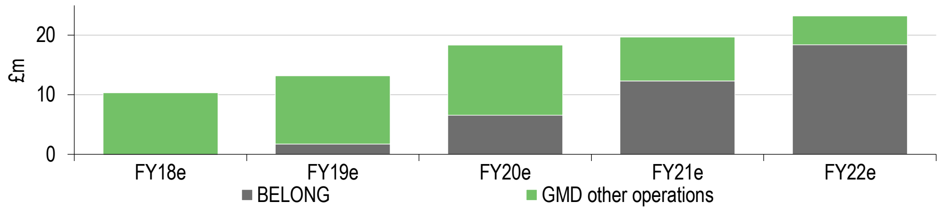
Valuation: BELONG and cash alone are worth 55p

We value GMD on three metrics: peer comparison, DCF and sum of the parts, which results in a valuation range of 61-93p. Our peer valuation of 93p (previously 88p) is averaged between comparison with US operator, GameStop, and UK special interest operators. Our DCF valuation using a high 15% WACC to reflect execution risk, is 61p (previously 71p). Our sum of the parts adds the BELONG roll-out valued as a project, net cash, and the existing business conservatively valued as a perpetuity at 30%. Those elements sum to 71p (previously 62p). Our blended valuation between these three metrics is 75p (previously 74p). However, we note that our sum of the parts indicates that BELONG and cash alone are worth 55p per share.

Company description: All about the game

Game Digital (GMD) is a multi-channel retailer in the video game market. Its products range from playing experiences and events to hardware and software. It is the UK and Spanish leader in the new console market with a 26% and 38% share respectively. Its strategy is to move from lower-margin product retailing towards high-margin gaming experiences, and it is currently driving this through its BELONG concept, under a collaboration agreement with SPD, its largest shareholder. Over the next five years, we expect BELONG to become the predominant contributor to EBITDA (Exhibit 1).

Exhibit 1: Tomorrow belongs to BELONG



Source: GMD, Edison Investment Research (FY21-22 per DCF forecast)

GMD was admitted to the premium segment of the LSE in June 2014 at 200p, after the predecessor business, Game Group, entered administration in the UK in 2012. Game Group had a focus on product retailing, with c 870 stores. GMD now has 542. Reductions were mainly in the UK, now roughly halved to 277. In the more stable Spanish market the estate of 265 is little changed.

Game Digital's strategy: The experience emerges

In GMD's 2014 prospectus, its strategy was summarised as "to drive profitable growth and enhance shareholder value by continuing to build on its market leading position as an omni-channel specialist retailer of video games in the UK and Spain." Priorities in the overall strategy were to:

1. maximise market share of console physical content;
2. maximise market share of console and non-console digital content;
3. promote pre-owned products to both capture market share and grow the absolute market; and
4. broaden product and service offering and target a broader gaming community.

Since IPO, GMD has placed progressively more emphasis on (4) above, linking its market development primarily to the customer experience, while relying on that relationship to attract related product sales. That emphasis has now been formalised in the collaboration agreement.

Collaboration agreement: Powering up the experiential model

In February 2018 GMD signed an agreement with its 25% shareholder SPD to accelerate the roll-out of its BELONG gaming arena concept and/or GAME retail units. SPD paid £3.2m for 50% of the existing BELONG business, comprising 19 units in GMD stores.

The collaboration agreement is formally a profit sharing agreement, not a joint venture agreement. It commits GMD and SPD to develop BELONG gaming arenas and GAME retail operations in a range of formats:

- Standalone BELONG arenas;
- BELONG arenas in or next to GAME retail stores;
- BELONG arenas in SPD retail stores;
- GAME retail stores within SPD retail stores; and
- BELONG arenas with GAME retail stores, within SPD retail stores.

Under the agreement, each unit will be jointly agreed before being committed. Operating profits will be split equally (after a GMD management fee). Where BELONG and GAME retail units are established within SPD stores, the operating team will be controlled by GMD. Rent will be negotiated as normal for a concession. Fit-out costs will be borne by GMD, financed by a £35m capex loan facility, and SPD also provides a £20m working capital facility (loan details page 12).

BELONG's roll-out to date has demonstrated average payback of 16 months, but also that the optimum scale is formats above 24 playing positions. Management now plans a roll-out of up to 5,000 BELONG playing stations in the UK, and to initiate BELONG in Spain in early 2019.

The large number of current lease expiries is attributable to the fact that the UK business was incorporated out of administration in 2014. Over 230 leases expire in the next year and there is an average time to break of one year.

As a result, GMD has significant flexibility to move into larger sites, to accommodate the roll-out of BELONG. SPD contributes its retail presence and fast-developing estate with increasing numbers of larger stores. Management expects future BELONG sites will have an average of 40 desks, with varying sizes.

Why BELONG is important: A step change in strategy

The collaboration agreement marks a step change in the evolution of GMD's strategy, accelerating the impetus to penetrate experiential areas, so engaging with customers more fully.

- The initiative should position BELONG as market leader in local and regional e-sports.
- High occupancy: existing units that conform to the template already achieve 29% utilisation.
- High margin: gross margin for pay-to-play is 100%. Including food and drink, PC hardware, accessories, digital products and VR, gross margin is 45% and, after incremental rent, labour, supplier contributions and management fees, GMD projects that its retained share of operating profit will run at 23% of total revenue.
- The investment in fit-outs, combined with supplier support, has low capex with fast payback. GMD believes it should generate operating profit share of £150-175k per arena, against a capital investment of £350k on average. We model year 3 ROI (GMD share) of 48%.
- The agreement is strategically important for both parties, so should receive close attention.
- BELONG is powerful in recruiting new customers: one in four is new to GAME.

Sports Direct's elevation strategy: A tailwind for BELONG

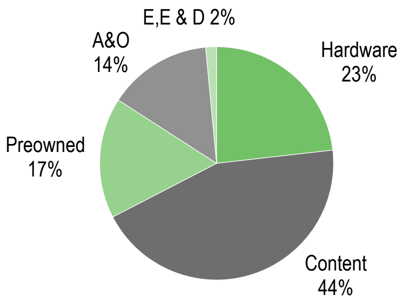
SPD is engaged in its "elevation strategy" designed to expand its brand across market levels and product areas. As stated in its final results: "The enhancement of our retail proposition…continues to be a strategic priority…Our multi-channel elevation strategy is a key driver towards…our long to medium term goal of delivering an unrivalled multi-brand offering to customers across sport, lifestyle and fashion…This strategy began on the high street with the active management of our property portfolio…to open a new generation of stores. These include regional flagship stores with multiple fascias in key retail locations. *This is enabling us to work closely with our third party brand partners to ensure greater integration of key products within improved retail space*." (our italics).

SPD's commitment to its elevation strategy sheds much light on its decision to acquire the stores, stock and business of House of Fraser, and its intention, surprising to some, to keep c 80% of its stores open. Although this acquisition brings further complexity to the process for realising the collaboration agreement, we see it as a medium-term opportunity for the BELONG roll-out.

The underlying business: Two classes of activities

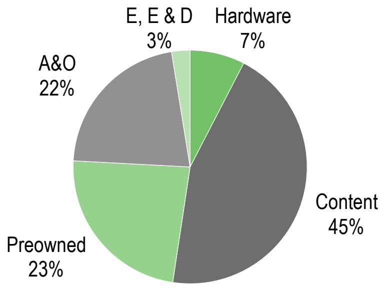
We examine below GMD's current activities, distinguishing between those that tie it to the gaming cycle and those that develop independence from the cycle.

Exhibit 2: FY18e GTV by category



Source: Edison Investment Research

Exhibit 3: FY18e gross profit by category



Note: E,E & D = Esports, Events and Digital

Cyclical activities

Console content: GMD retails a wide range of content for consoles and PCs, including both physical boxed software and digital content – see www.game.co.uk. Through close supplier relationships, GMD negotiates exclusive editions of many standard games, including value features such as additional digital content or in-game items, for instance vehicles and weapons.

Looking through any disruption attributable to Fortnite (see page 7 below), we expect underlying market share to reduce slightly in the next two years as digital purchasing increases. GMD's share of the console digital content market is lower that for physical content (FY17:10.4% in the UK), albeit its share of digital sold at retail is very high, and digital content sales also contribute lower gross margin to GMD at 14% of GTV against c 25% for physical games (H118). However, this should be countered in FY19 by a strong release schedule of new games such as *Call of Duty: Black Ops 4* (October 2018) and *Fallout 76* (November 2018), and in addition GMD is working to maintain and increase its share, which grew 1% in FY17. Beyond this there is some resistance to digital caused mainly by long download times and an inability to trade in used games.

Hardware: Hardware is a natural market for GMD as it is a material customer purchase, meaning that trial and knowledgeable service are of value. GMD also benefits from trading in consoles and reselling at 30% margins, meaning the hardware ecosystem is profitable. The 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 is apparent from Exhibit 9, console hardware creates much of the volatility of the cycle, both directly and through related content releases. Hardware margins are low: between 3% and 7%, although bundles can be up to 10%. However, contact with hardware customers is key to GMD's penetration, with knowledgeable store staff clearly differentiating against competition.

Pre-owned products: Pre-owned is a significant area, contributing 23% of gross profit (FY18e). 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. Pre-owned consoles continue to present an opportunity to GMD.

Cycle-independent activities

Accessories and Other (A&O) mainly consist of controllers, headsets and plugs, connectors and other parts collectively known as GAMEware. Growth in the category reflects the developing range and sophistication of games. It has benefited from the Fortnite phenomenon (page 7 below), where advanced controllers and headsets are needed to compete. A&O also includes VR, where sophisticated headsets sell for £350-1,000, while mobile-driven versions are priced as little as £20 (average spend is c £270). The future profile of VR is still uncertain but could be large.

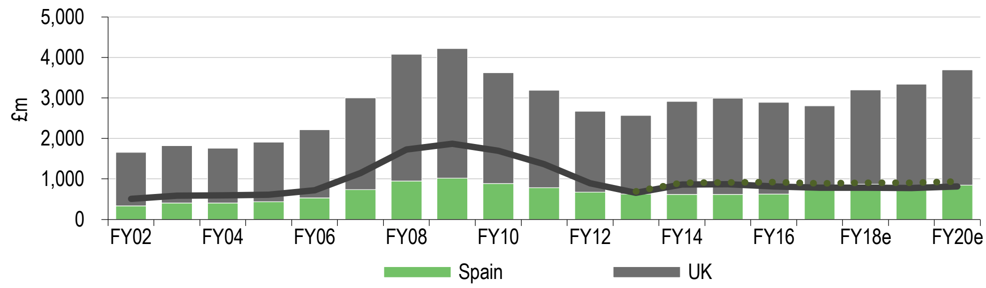
Gametronics: Mobile gaming has outgrown gaming on other devices to exceed 50% of the global market in 2018, as projected by Newzoo. Gametronics (c 30% of pre-owned GTV) represents pre-owned mobile and tablet hardware suitable for gaming and is driven positively by this trend.

Events, Esports and Digital (E, E & D): The global e-sports market is US$0.7bn, growing to US$1.5bn by 2020 (source: GMD). This is a significant strategic area for GMD, led by BELONG, as above. Other components of E, E & D are Game Esports and Events, Ads Reality, and Game Esports Spain. In H118 gross margin improved 15.7bp to 32.6%, mainly reflecting higher margins on events such as Insomnia. With flat costs, the EBITDA loss reduced from £2.8m to £1.1m y-o-y.

GMD in its markets: Dynamic and volatile conditions

Traditionally the video game cycle has been driven by major hardware releases with Microsoft and Sony creating a demand cycle of c six years, with content peaking two to three years later, However, that cyclicality is starting to be flattened by the greater mix of digital product such as Fortnite and V-Bucks that are not related to the console cycle.

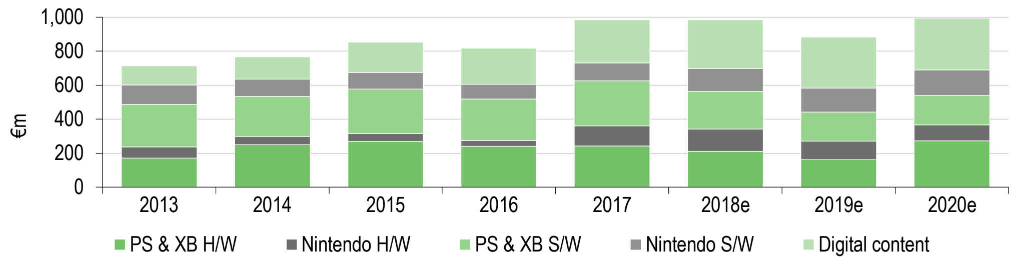
Exhibit 4: Riding the cycle – GMD revenue vs the UK and Spanish video games market (£m)



Source: GMD, Edison Investment Research forecasts

The Spanish market, responsible for c 36% of GMD's GTV, has always provided some stability to the company and we expect this to continue.

Exhibit 5: The Spanish video games market

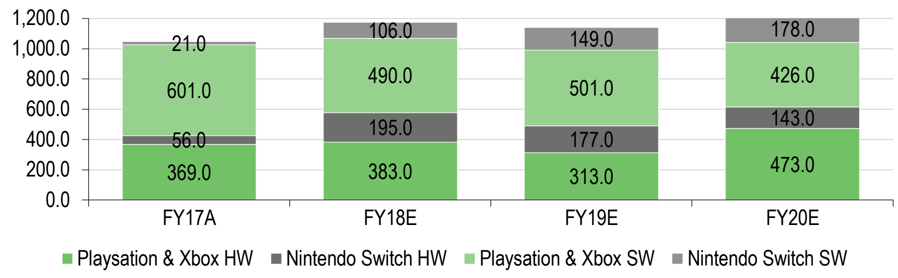


Source: GMD based on market data

PlayStation, Xbox and Nintendo: A Switch of consumer interest

With its Wii console Nintendo showed an ability to disrupt the market, driving c £1bn of UK sales in 2008, and creating a new class of gamers (such as families) through related content offering. The disruptive success of the Nintendo Switch, launched in March 2017, despite initial global supply issues, means it has become core to the gaming product market, both hardware and content, as shown by the UK market summary below:

Exhibit 6: UK market, hardware and software (£m) – Switch invades core markets

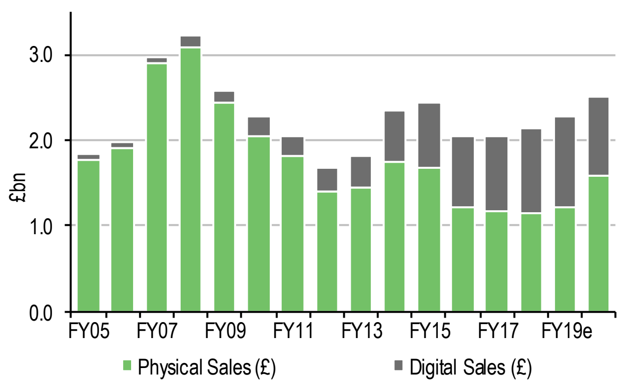


Source: GMD based on market data

Nintendo underpins the console market

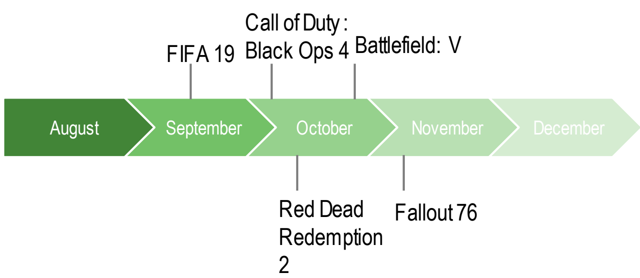
Growth of Nintendo content is expected to continue thanks to a strong pipeline of upcoming releases. In addition cross-console titles like *Call of Duty: Black Ops 4* and *Fallout 76* should provide an element of recurring revenue:

Exhibit 7 UK console cycle



Source: GMD based on market data

Exhibit 8: UK game releases – big name titles

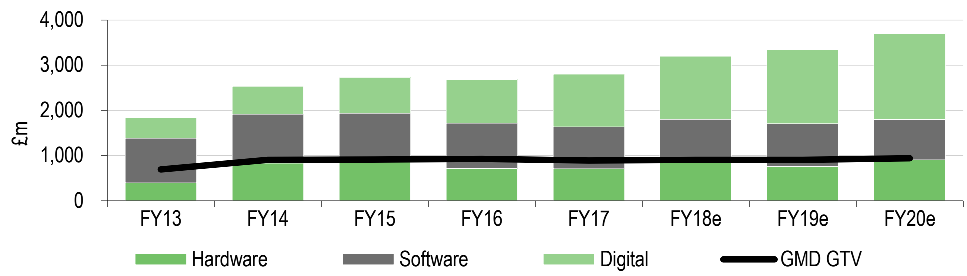


Source: GMD based on market data

Digital vs console content, and the Fortnite effect

Currently, market forecasts for the UK and Spain for the next two years assume steady growth largely driven by digital content, but we forecast GMD's revenue as expressed by GTV to remain relatively constant, even though that represents an overall declining share of the product market:

Exhibit 9: UK and Spanish market – console hardware, software and digital



Source: Market forecasts via GMD, Edison Investment Research

The global gaming market is currently being skewed by *Fortnite: Battle Royale*, a digitally downloaded game that is free-to-play with paid add-ons. Launched in July 2017, Fortnite is a combat and survival game, which already has 125 million registered users (source: techradar.com). It has become a worldwide craze among school-age children as well as core gamers, and has led to a number of concerned articles in the broadsheet press with reports of children becoming addicted.

The direct effects on GMD have been both positive and negative. Digital sales, as we infer (below, page 9) were ahead in H218 at the expense of physical content. Fortnite can be played on Xbox, PlayStation 4 and Nintendo Switch consoles as well as iOS, PC Mac and Android, and hardware sales have been strong, we understand. Fortnite has a particular requirement for headset hardware, so that US headset manufacturer, Turtle Beach, saw its Q1 sales increase by 185% to US$40.9m, and its share price rise around 800% to US$18 as a result. Players are also upgrading their game controllers, and both factors correspond with strong accessories sales at GMD in H218, we understand.

It is currently unclear to what extent the market changes that GMD saw in H2 may extend to the future or whether the market will revert to its previous pattern. For the moment we assume the latter in forecasting FY19, treating Fortnite as a craze akin to Pokemon Go that will be temporary.

Management: Commercial emphasis

Management biographies are on page 15. Martyn Gibbs continues to lead the company as it manages its fast changing market, where his 25 years' gaming and retail experience is more relevant than ever. GMD has been without a finance director since March 2018. Ray Kavanagh, interim CFO, is a commercially experienced financial manager with 18 years' experience in retail.

Sensitivities: The challenge to lead a changing market

We group the main share price sensitivities under the following headings:

Strategy risk: GMD's change strategy embodies significant execution risk. In particular, the collaboration agreement with SPD increases dependency on another company. SPD's recent House of Fraser acquisition, while positive in the medium term, could overlay short-term complexity.

Unpredictable market: GMD is in a fast-changing gaming market that could differ from projections, either favourably or unfavourably. In forecasting GMD's results, we refer to market projections that assume progression in key areas that could in practice turn out differently.

Technical developments could be unexpected: Technical developments may be different to our assumptions. For example, 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: Product-led changes such as 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 significant effects. Similarly, the failure of a major gaming title can adversely affect sales and profitability.

New markets could develop differently: The company's development of new markets such as events, e-sports and BELONG could have a greater or lesser effect on results than we assume.

Earnings may be volatile: Operating leverage is high, so earnings may be volatile, although management's continued focus on and demonstration of significant savings to date indicates the ability to mitigate that.

Financials: Challenges, cost action, BELONG progress

Interim results and the collaboration agreement

Exhibit 10: Summary of interim results to January 2018

£m	H117	H118	±
Gross transaction value	565.4	586.8	3.8%
Revenue	498.1	517.4	3.9%
Gross profit	127.1	123.1	-3.1%
Operating costs	-103.8	-101.9	-1.8%
EBITDA	23.3	21.2	-9.0%
PBT	16.9	14.2	-16.0%

Source: GMD. Note: EBITDA and PBT are adjusted.

Results showed a cyclical decline. EBITDA was down 9% year-on-year, mainly resulting from mix-related margin declines, partially mitigated by operational efficiencies and cost savings.

There was a strong retail market both in the UK (+14.3%) and Spain (+13.5%), driven primarily from strong sales of Nintendo Switch and associated software. The Xbox One X, launched in November 2017, had more impact in the UK than Spain.

GTV was up by 3.8%, a blend of a 0.3% UK decline and a 7.5% local currency growth in Spain with a c 4% positive foreign exchange effect. The UK had extreme mix variation, with console sales up 27.3% but mint software down 1.7%. The latter reflected 3.9% fewer UK stores, but also a shift to online product. In Spain, hardware and content grew by 16.5% and 7.4% respectively. Combined, hardware was up 24.7% and content up 1.2%.

Within Accessories & Other (A&O), the core category was down 4.7%, with console accessories following the hardware growth online, while VR sales lagged major launches last year. However, Events and Esports, still small at £7.1m, were up 31.5% on acceleration in BELONG and events. Pre-owned declined 8.6%, reflecting core categories tracking mint software performance in FY17.

Gross margin based on GTV slipped 150bp, representing a 3.1% gross profit decline, primarily caused by higher mix of low-margin hardware. That was mitigated by realised cost savings of £5m, across property, payroll, procurement and distribution. A UK reduction of £4.0m was reduced by volume-related retail cost increases in Spain, meaning the net cost decrease was £1.9m.

Pre-close at August 2018: Mix issues, cost actions

Full-year GTV growth was 1.8% after a 1.6% H2 decline. Reported revenue was marginally lower y-o-y at c £780m. The trends of H1 continued in H2, with strong sales of lower-margin digital and hardware products, and continued challenges in pre-owned affecting gross profit. However, where quality new releases had launched such as *God of War III*, volumes were positive. It is apparent that mix trends actually intensified in H2, taking core retail GTV from growth of 3.6% in H1 to H2 decline of 1.3% (based on our forecast of Events, Esports and Digital share of UK sales, Exhibit 11 below), with a more pronounced effect on revenue indicating the effect of digital.

GMD continues to deliver cost savings in the UK to mitigate challenges in its core console market, with a target of £6.0m in H218. In particular, significant progress has been made on UK cost reductions related to retail leases. The weakness of this property market has been well publicised, and the fact that a large proportion of the stores have current or short-term lease events – there are over 230 expires in the next year and there is an average time to break of one year – places the company in an even stronger position to negotiate with landlords. Management signals further cost savings resulting from reorganisation of the head office and distribution functions in H2 and a review of contracts.

Collaboration agreement progress

The scope of the collaboration agreement, the scale of new SPD developments, the dynamics of the retail property market and the need to co-ordinate with SPD's process, have together produced some initial inertia in implementing the BELONG strategy. Following the agreement, detailed planning has been completed. The first resulting arena opened in Westfield Stratford on 17 August 2018, and the second at Lakeside Thurrock is set to open imminently. At a capacity of 50+ and 24+ gaming desks respectively, these are larger than the current average of 18 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. The process is now active and management now expects a total of 20 sites to open in FY19, albeit weighted to the second half.

SPD's recent acquisition of House of Fraser clearly provides an opportunity in terms of prominent sites suitable for the kind of flagship store envisaged by its elevation strategy, which includes BELONG arenas as well as GAME retail operations. However, in the short term, the addition of the sites risks further overlaying an already complex planning and implementation process between parties.

Earnings forecast: We have trimmed our FY18e EBITDA

Exhibit 11: Actual and forecast results

	Results								Growth/margin		
£m	**H117**	**H217**	**FY17**	**H118**	**H218e**	**FY18e**	**FY19e**	**FY20e**	**FY18e**	**FY19e**	**FY20e**
GTV											
Core Retail UK	366.7	195.3	562.0	365.5	190.4	555.9	530.6	528.8	-1.1%	-4.5%	-0.4%
Core Retail Spain	191.0	124.8	315.8	212.4	125.5	337.9	348.0	358.5	7.0%	3.0%	3.0%
Core Retail Total	557.7	320.1	877.8	577.9	315.9	893.8	878.7	887.3	1.8%	-1.7%	1.0%
Events, Esports & Digital	7.7	5.5	13.2	8.9	4.5	13.4	24.7	49.5	1.7%	84.4%	100.1%
Total GTV	565.4	325.6	891.0	586.8	320.4	907.2	903.4	936.8	1.8%	-0.4%	3.7%
Revenue											
Core Retail UK	320.2	171.1	491.3	320.0	151.7	471.7	450.3	448.8	-4.0%	-4.5%	-0.4%
Core Retail Spain	170.2	108.2	278.4	188.5	106.4	294.9	303.7	312.8	5.9%	3.0%	3.0%
Core Retail Total	490.4	279.3	769.7	508.5	258.1	766.6	754.1	761.6	-0.4%	-1.6%	1.0%
Events, Esports & Digital	7.7	5.5	13.2	8.9	4.5	13.4	24.7	49.5	1.7%	84.4%	100.1%
Total revenue	498.1	284.8	782.9	517.4	262.6	780.0	778.8	811.1	-0.4%	-0.2%	4.1%
Gross profit											
Core Retail UK	84.7	49.8	134.5	77.2	46.2	123.4	121.2	116.3	22.2%	22.8%	22.0%
Core Retail Spain	41.1	27.0	68.1	43.0	25.4	68.4	70.5	72.6	20.2%	20.2%	20.2%
Core Retail Total	125.8	76.8	202.6	120.2	71.6	191.8	191.7	188.9	21.5%	21.8%	21.3%
Events, Esports & Digital	1.3	1.2	2.5	2.9	2.1	5.0	9.8	20.5	37.4%	39.5%	41.4%
Total gross profit	127.1	78.0	205.1	123.1	73.7	196.8	201.5	209.4	21.7%	22.3%	22.3%
EBITDA											
Core Retail UK	13.4	(11.6)	1.8	9.9	(8.7)	1.2	1.6	1.6	0.2%	0.3%	0.3%
Core Retail Spain	12.7	(0.5)	12.2	12.4	(2.4)	10.0	9.7	9.4	3.0%	2.8%	2.6%
Core Retail Total	26.1	(12.1)	14.0	22.3	(11.1)	11.2	11.3	11.0	1.3%	1.3%	1.2%
Events, Esports & Digital	(2.8)	(3.2)	(6.0)	(1.1)	0.0	(1.0)	1.9	7.3	-7.8%	7.8%	14.8%
Total EBITDA	23.3	(15.3)	8.0	21.2	(11.0)	10.1	13.2	18.3	1.1%	1.5%	2.0%

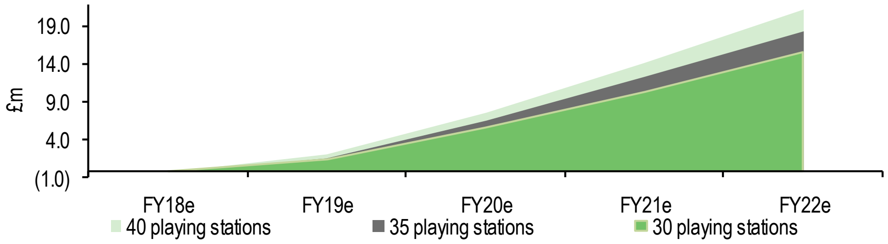
Source: GMD, Edison Investment Research

Following the pre-close, in our 21 August 2018 note, Pressures countered: BELONG moves ahead, we trimmed our FY18 EBITDA forecast by 7% to £10.1m, although it still represents y-o-y growth of 26%, with our pre-tax forecast also reflecting higher depreciation. Our EPS forecast of -4.1p (previously -0.6p) also reflects higher tax relating to non-offsettable Spanish profits and one-off items. For FY19 we trimmed EBITDA 13% to £13.2m (still y-o-y growth of 31%), also reflecting the knock-on effect of initial inertia in BELONG. For FY20 we reduced our EBITDA forecast by 27%, based on updated market forecasts, bringing it more in line with consensus. It still represents year-on-year growth of 38%. We make no further changes now.

BELONG scenario analysis

In forecasting BELONG, we modelled three cases based on average desk size of each site, all larger than the current average of 18 desks.

Exhibit 12: BELONG EBITDA, GMD share – large, small and median cases



Source: Edison Investment Research

Case 1 is a conservative size averaging 30 desks per site, our median Case 2 assumption is 35 desks, and Case 3 assumes 40 desks. In addition, we assume a 5% increase in utilisation efficiency in H218 fading to 2% by FY22. In all cases, we assume 20 openings in FY19 and 29 in each subsequent year. The three cases result in a total of 3,544, 4,079 and 4,614 playing stations respectively, the latter approaching GMD's target of 5,000.

However, we include the less aggressive median case in our forecast, which therefore leaves upside if the company achieves its own target:

Exhibit 13: Median case BELONG roll-out

£m	FY18e	FY19e	FY20e	FY21e	FY22e	Run rate
Total arenas end of period	19	39	68	97	126	126
Desks per new arena	35	35	35	35	35	35
Total desks end of period	334	1,034	2,049	3,064	4,079	4,079
Possible hours per arena per week (000's)	26.1	80.7	159.8	239.0	318.2	318.2
Utilisation	29.8%	32.4%	34.7%	36.7%	38.3%	38.3%
Total pay-to-play revenue	1.8	4.5	10.7	18.1	25.9	28.5
Other revenue (PC, VR & F&B)	4.4	11.2	26.8	45.2	64.8	71.2
Total revenue	6.2	15.7	37.5	63.2	90.8	99.7
Growth (%)		153.1%	138.3%	68.5%	43.5%	9.9%
EBITDA	(0.2)	1.7	6.6	12.3	18.4	21.9
EBITDA margin (%)	-2.7%	10.9%	17.6%	19.4%	20.3%	22.0%
Change in working capital	(0.2)	(0.4)	(0.9)	(1.6)	(2.3)	(2.5)
Capex	(0.4)	(7.0)	(10.2)	(10.2)	(10.2)	(4.4)
Tax	(0.1)	(1.3)	(0.9)	(0.5)	(2.1)	(4.4)
Free cash flow	(0.9)	(7.0)	(5.4)	0.0	3.9	10.7

Source: Edison Investment Research

Cash flow: Entering investment phase, but small net impact

Since we initiated in April 2017, the structure of GMD's overall development plans has changed fundamentally. A year ago, GMD was developing a range of growth activities, countering cyclical decline, and we expected both to become significantly positive by FY20. Now, with core retail market forecasts having flattened, GMD is more focused on the roll-out of BELONG, leading to both cash investment and earnings progression. However, we do not expect a material effect on cash flow as the company intends to support its investment in BELONG, which we forecast at about £10m pa, by switching planned capex from other areas such as non-BELONG retail development and digital solutions.

Exhibit 14: Cash flow forecast

	FY18e	FY19e	FY20e
EBITDA - pre-except	10.1	13.2	18.3
Working capital	5.1	(1.8)	0.0
Share-based payments	2.3	2.3	2.3
Operating cash flow	17.6	13.7	20.6
Capex, net	(14.4)	(17.0)	(17.2)
Interest	(0.8)	(1.0)	(1.8)
Tax	(4.0)	(2.4)	(2.3)
Free cash flow	(1.7)	(6.8)	(0.7)
Disposals, other	16.0	4.6	–
Net cash flow	14.3	(2.2)	(0.7)

Source: Edison Investment Research

Balance sheet: Very adequately protected

We forecast FY18 net cash of £56.1m to change only slightly in FY19 to £53.2m. As this will be net of around £10m of BELONG expenditure to be financed under the SPD facility, gross cash should increase to £66m.

GMD has total facilities of £130m, potentially increasing 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: Significant upside on all metrics

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

Peer comparison: Few close matches

There are no listed UK companies in GMD's market. The US operator GameStop resembles the predecessor Game Group rather than GMD. It trades on year 1 and 2 EV/EBITDA of 3.4x and 3.7x, implying an unchanged GMD value of 59p. Also relevant in our view (as they serve special interest groups) are UK small-caps Games Workshop, Goals Soccer Centres, and Focusrite. These trade on an average year 1 and 2 EV/EBITDA of 13.9x and 13.1x respectively, implying a GMD value of 126p. Averaging the two peer comparisons results in 93p (previously 88p).

DCF valuation: Valuing the medium-term strategy

DCF is an appropriate metric since it takes account of medium-term strategy, albeit this is clearly subject to execution risk. In view of that, we apply a 15% WACC. Reflecting flatter market forecasts, we model revenue growth peaking at 7.5% (previously 10%) in FY21 before fading to a terminal 2%. As before, we assume a terminal EBITDA margin of 4.2% (FY18e: 1.3%, FY20e: 2.3%) and capex at 2% of revenue. As a result, we value the shares at 61p (previously 71p). That is c 10p sensitive to a 1% change in WACC and c 20p sensitive to a 1% change in the margin assumption.

Exhibit 15: Share price sensitivity to WACC and terminal growth

p per share	Terminal growth				
WACC	1.0%	2.0%	3.0%	4.0%	5.0%
20.0%	46.9	47.4	48.0	48.7	49.5
17.5%	52.2	53.1	54.1	55.3	56.6
15.0%	59.9	61.4	63.2	65.3	67.8
12.5%	71.6	74.4	77.7	81.9	87.2
10.0%	90.7	96.5	103.9	113.7	127.5

Source: Edison Investment Research

Sum of the parts: Focus on the growth element

a) **BELONG roll-out.** We model BELONG as a project, based on the model in Exhibit 13. This assumes no further roll-out beyond FY22. Using a 15% WACC and 2% terminal growth rate, and maintenance capital only in the terminal period at 10% of the total investment, this produces a valuation of £39.2m or 23p per GMD share. If we were to assume continued roll-out of the concept over 10 years with revenue growth rate fading to the terminal 2%, our valuation would be £49.2m or 28p per share. However, we do not include this assumption in our valuation.

b) **Net cash.** Net cash at July 2018 was £56.1m or 32p per share.

c) **The existing business.** The core retail business is substantially the source of GMD's current EBITDA of £10.1m (FY18e). Over the period FY18-20e, we see this business in a flat range of £11.0-11.2m EBITDA. There are medium-term questions about the operation's sustainability. On one hand, it is threatened by increasing market share of digital. On the other, the entire strategy and the collaboration agreement in particular should support the product business. For prudence, we value the income stream (after tax at 25%) at a 30% perpetuity rate to give £27.9m/16p, which is approximately the same as assuming that that income stream decreases to zero over 10 years, at a WACC of 15% (£30.2m/17p).

On this basis, the sum of the parts is 71p (previously 62p).

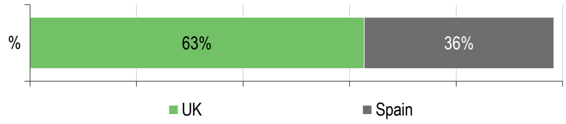
Summary: 75p, with BELONG and cash alone worth 55p

Averaging all three metrics, we define a blended valuation of 75p (previously 74p). We note, however, that our sum-of-the-parts analysis indicates that BELONG and cash alone are worth 55p.

Exhibit 16: Financial summary

Accounts: IFRS, Year-end: July, £m	2015	2016	2017	2018e	2019e	2020e
PROFIT & 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
CASH FLOW 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: GMD, Edison Investment Research

Contact details	Revenue by geography
Game Digital Unity House Telford Road Basingstoke RG21 6YJ +44 (0)1256 784000 www.gamedigitalplc.com	

Management team

CEO: Martyn Gibbs	Chairman: John Jackson
Martyn Gibbs was appointed to the board on 15 May 2014, having been CEO of Game Retail since April 2012. Martyn has 25 years' experience in the retail sector and 20 years' experience in the video games industry. His previous roles include managing director of the Game Group for the UK, Eire, Scandinavia and the Czech Republic from 2010 to 2011, customer and brand director of the Game Group from 2009 to 2010, MD of Gamestation from 2007 to 2009, commercial director of Gamestation from 2003 to 2007, head of games of HMV for the UK and Eire from 2000 to 2003, and various store management, central operations, marketing and buying roles at WH Smith from 1989 to 2000.	John Jackson joined the board on 16 May 2014. He is also non-executive director for Wilkinson Hardware Stores and non-executive chairman for the Rick Stein Group. John's previous roles include group chief executive of Jamie Oliver Holdings from 2007 to 2015, group retail & leisure director of Virgin Group from 1998 to 2007, group chief executive of Semara from 1994 to 1998, MD of The Body Shop International from 1988 to 1993, MD of Chesebrough-Pond's from 1982 to 1986, MD of Bristol-Myers Pharmaceuticals from 1979 to 1982 and group finance director of Bristol-Myers from 1972 to 1979. John is chairman of the Nomination Committee.

Principal shareholders	(%)
Sports Direct International	25.4
Miton Group	15.0
Canaccord	11.8
Wasatch Advisors	7.2
Schroders	6.6
Pendal Group	5.1
Capita	2.6
River & Mercantile Asset Management LLP	2.5
Hargreaves Lansdown Asset Management	2.2

Companies named in this report

Sports Direct International (SPD.L), GameStop (GME), Nintendo (NTDOY), Games Workshop Group (GAW.L), Goals Soccer Centres (GOAL.L), Focusrite. (TUNE.L)

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