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GME - Q2 2013 Gamestop Corp. Earnings Conference Call

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OVERVIEW:

Management discussed 2Q13 results, reporting consolidated global net earnings of \$10.5m, or \$0.09 per diluted share on consolidated global sales of \$1.38b. Guidance was for 3Q13 diluted EPS of \$0.50-0.55 on same store sales up 11-15% vs. 3Q12, and for 2013 EPS of \$3.00-3.20 on comp store sales down 3.5% to up 1.5% vs. 2012.



CORPORATE PARTICIPANTS

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Rob Lloyd *GameStop Corp. - EVP and CFO*

Tony Bartel *GameStop Corp. - President*

Mike Mauler *GameStop Corp. - EVP GameStop International*

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PRESENTATION

Operator

Good morning, and welcome to the GameStop Corporation's GameStop second-quarter 2013 earnings conference call. At the conclusion of the announcement, a question-and-answer session will be conducted electronically. (Operator Instructions).

I would like to remind you that this call is covered by the Safe Harbor disclosure contained in GameStop's public documents and is property of GameStop. It is not for rebroadcast or used by any party with the prior written consent of GameStop.

At this time, I would like to turn the call over to Mr. Paul Raines, Chief Executive Officer of GameStop Corporation. Please go ahead.

Paul Raines - GameStop Corp. - CEO

Thank you, operator. And welcome to the second-quarter earnings call for GameStop. As always, we are grateful to our associates around the world for their performance and dedication to customers this quarter. They are the secret to GameStop's success.

Joining me today on our call are Rob Lloyd, Chief Financial Officer; Tony Bartel, President; Mike Mauler, Executive Vice President of International; Mike Hogan, Executive Vice President of Strategic business; and Matt Hodges, our Vice President of investor relations.

The second quarter exceeded expectations, with earnings per share beating the high end of our guidance by \$0.02. We also produced another strong quarter of margin expansion of 130 basis points. GameStop has now grown margin rate for nine consecutive quarters, reflecting ongoing strength of the new businesses we are building.

Comparable sales came in better than our guidance, but still challenging as we closed out the current console cycle.

Although the second quarter is the lowest volume quarter of the year, we set aggressive execution goals for our teams around the world. And I am pleased to say the team delivered.



The hard work of controlling costs and managing expenses is just as important as the exciting work of driving sales, especially at the end of a console cycle. Rob Lloyd will share details of our performance in his remarks.

We continued to gain market share this quarter, and our digital and mobile businesses continue to perform well. We are positioned well for the upcoming console launches, and expect to be the dominant player during this cycle. The unique value of the buy/sell trade model has been reaffirmed by our partners, and will bring over \$1 billion per year of trade currency to consumers for their new console purchases.

Tony Bartel will share some of the highlights of our US performance with you later on the call, as well as giving you some insight on how we will execute what will be the largest console launch in history.

On the international front, we also saw dramatic growth in digital and mobile while experiencing negative comps, particularly in Europe. We continue to see improved execution in the international area on our core processes while also rolling out digital and mobile businesses. Mike Mauler will share with you some color on the international business this quarter.

We have asked Mike Hogan to touch on a couple of strategic subjects for investors on this call. As console launch visibility has improved, we have some greater detail to share with you on our market model. Mike will also provide an update on PowerUp Rewards.

Reflecting on our recent history, we have navigated through nine consecutive quarters of negative comps, as our industry has declined 38% since 2008. During that same time period, GameStop's sales and operating earnings were relatively flat, and earnings per share increased 33%. These results were accomplished with a formula of innovative change, strong execution, and capital discipline.

Our new businesses of digital and mobile have provided consumers with fresh and exciting ways to engage with their favorite GameStop store or digital platform while providing us richer margins.

We have taken share through strong execution and innovative marketing. The launch of PowerUp Rewards in 2010 has now added 25 million members in the United States, and six million members in Europe and Australia, who see us as their trusted game advisor.

Lastly, we have dedicated ourselves to returning free cash flow back to investors, buying back \$1.2 billion of our shares at a large discount to today's market price while eliminating debt and launching a dividend. In the past quarter alone, we repurchased almost \$89 million of our shares, reaffirming our commitment to shareholders.

While we have a lot of work ahead of us, we are proud of the transformation we have gone undergone in recent years and are excited about the future of GameStop. We believe that we are a unique case study of evolution from a pure physical store footprint to a hybrid digital and physical retailer operating globally in the electronics and technology space.

Our commitments to investors remain steadfast. We will drive a high rate of internal change to keep GameStop ahead of the curve. We will continue to execute at a best-in-class level to serve our customers. And we will return free cash flow to shareholders.

I will now turn the call over to Rob.

Rob Lloyd - GameStop Corp. - EVP and CFO

Thanks, Paul. Good morning. I'd like to begin by reviewing our second-quarter results. GameStop's consolidated global sales were \$1.38 billion, down 10.7% from the prior-year quarter. With comps also down 10.7%; down 10.2% in the US, and down 11.6% internationally. Our same-store sales were better than the high end of the range we outlined in last quarter's call.

We stated in May that there were a few major releases in the quarter. We were very pleased with our performance on The Last of Us, which was the best-selling title during the quarter. As a result, new software sales declined 9.3%, compared to a 19.4% decrease in the US market. Overall, we



gained 290 basis points of new software market share in the quarter. Our hardware sales outperformed the US market, leading to a hardware share gain of 380 basis points.

Pre-owned sales decreased 6%, compared to the prior-year quarter. The US was down 7.7% and international was down 1.5%, excluding currency movement. Our pre-owned business outperformed the overall videogame market, which declined more than 19% in the US. Our digital business increased 18% over the second quarter of last year, with growth in PC digital and international console digital. Our digital receipts, or non-GAAP revenue, totaled \$158 million, with GAAP revenues totaling \$50 million. Tony will have more color on digital growth.

Our mobile revenues grew 121% to \$55 million; \$24.9 million in the second quarter of last year. Our trade traffic continues to accelerate, and we continue the international rollout of stores selling re-commerce products and tablets.

Consolidated global net earnings were \$10.5 million and diluted earnings per share for the quarter were \$0.09, exceeding our guidance range. Gross margins for the quarter were 34.8%, up 130 basis points from Q2 last year, driven by the growth in digital and mobile businesses and a shift in sales from new hardware to pre-owned. Gross margins in new hardware and new software each increased slightly when compared to the second quarter of 2012. Gross margins on pre-owned declined slightly from the same quarter of last year.

The margin rate in the other category increased from 38% in Q2 last year to 42% this quarter. We had growth in digital margin, which drove 140 basis points of the improvement. But the main driver -- with that last year during Q2, we were selling Diablo 3 on PC, which has a lower margin than other products in this category. Other, as a percentage of sales, declined from 21.3% to 20%, also due to the impact of Diablo 3 last year.

Digital gross margin grew 14% to \$34.8 million. Mobile gross margins were \$16 million at 29%. Total SG&A expense dollars declined 4.4% this quarter from last year and were down 3% on a per-store basis, as we continue to focus on controlling our SG&A.

Depreciation and amortization was also about 7% less than the prior-year quarter. We ended the quarter with 6505 stores. We opened seven and closed 46 in the US, and opened six and closed six internationally. We still expect to reduce our store base by about 2% this year.

Inventory was up slightly, reflecting an increase of 25% in pre-owned and mobile inventory, while our AP leverage declined. Remember that pre-owned and mobile recommerce inventory carry no payables, and therefore affect our AP leverage. The timing of new-release software also affects our AP leverage. And, as we shared last quarter, we'll return to more normalized levels next quarter.

As we indicated in the earnings release, our Board of Directors authorized the dividend of \$0.275 per share for this quarter to be paid on September 19. We repurchased 2.4 million shares in the second quarter at an average price of \$37.21 for a total of \$88.9 million. (inaudible) to date, we've repurchased 57.7 million shares at an average price of \$21.25, for a total of \$1.23 billion. We have approximately \$311 million remaining on our current buyback authorization.

Now, for the third-quarter outlook. We are pleased to be forecasting positive same-store sales, ranging from plus-11% to plus-15%. We are excited about the third-quarter title lineup, including Grand Theft Auto V, Battlefield 4, Assassin's Creed Black Flag, and others that Tony will discuss. Please note that Assassin's Creed releases in the third quarter this year and not the fourth.

We expect diluted earnings per share to range from \$0.50 to \$0.55, an increase of 31% to 45%, compared to \$0.38 for the third quarter last year. We are using weighted average fully diluted shares outstanding of 120 million, following buybacks to the second quarter. Based on our better-than-expected second-quarter results, as well as positive trends in new console pre-orders and higher launch-quantity allocation than we originally forecasted, we are increasing our full-year comparable store sales guidance from negative 5% to plus 1%, to now range from down 3.5% to up 1.5%.

We are also revising our previous full-year 2013 earnings per share guidance of \$2.90 to \$3.15, to a new range of \$3 to \$3.20 using weighted average fully diluted shares outstanding of 120.5 million, following buybacks for the second quarter. Earnings guidance does not include the effect of additional buybacks.



I'd like to point out that our third-quarter earnings guidance range is much higher than the current consensus estimate, and that the consensus estimate for the fourth quarter is much higher than our implied guidance. We believe there's a disconnect due to the timing of new releases, and that some of the fourth-quarter difference may be due to comparisons to last year that do not consider the \$0.08 per share impact of the 53rd week last year.

With that, I'll turn it over to Tony for his comments.

Tony Bartel - GameStop Corp. - President

Thanks, Rob. And good morning everyone. Today, I'm going to provide you with color on the upcoming console and title launches, and update you on our digital and mobile second-quarter performance and full-year forecast. We are optimistic and ready for the upcoming console launches and the strong software lineup. The software slate is as strong as it has been in years, and the launch of the new console that's seeing strong consumer demand.

Key launch titles in Q3 are Electronic Arts' Madden 25, FIFA 14, and Battlefield 4. Disney's Infinity, which is off to a very strong start, exceeding our expectations. Take-Two's Grand Theft Auto V, Activision's Skylanders SWAP Force, and Nintendo's Pokemon X and Y, Warner's Batman Arkham Origins, and UV Ubisoft's Assassin's Creed Black Flag.

Our software market share grew 290 basis points during Q2, and we are at record highs on both PS3 and Xbox 360 software share. So we are launching these strong new titles at our peak.

Our deep and long-standing relationships with the publishers allows us to offer intriguing and unique exclusive digital and physical content with each launch. This, along with the close customer relationships that we have with our 31 million PowerUp Reward members and through our knowledgeable associates, provides us with the ability to maximize physical, digital, and ancillary revenue at the time of launch. For instance, in the recent Disney Infinity launch, we offered customers the opportunity to pre-order and purchase over \$400 worth of characters in a single transaction. Similarly, on the upcoming launch of Grand Theft Auto V, we are the only US retailer to sell the exclusive \$150 collector's edition.

Our buy/sell trade model continues to make us the most affordable place to buy games, systems, digital content, consumer electronics, and accessories. Along with having trade-in deals on both new consoles, we now have two ways for PowerUp Reward members to buy new games for \$9.99. Either by trading in two recent current-generation games or by trading up to the Xbox One version of a recently launched game.

We will continue to work with our publishing partners to create unique ways to drive value that can only be found at GameStop.

For the console launches, our allocations from both Microsoft and Sony are much stronger than last launch. While we cannot disclose actual launch quantities for competitive reasons, we expect a significant increase in launch-day quantities versus the last console launch.

To put the launch efforts into perspective, we have increased our launch-period supply-chain capacity by 60% through the use of contracted distribution centers. By utilizing our reservation information and PowerUp Rewards First to Know list, we will be able to pinpoint these unprecedented launch quantities to the right locations and to drive logistic savings as well.

After completing our reservation programs for both consoles, we still have 1.5 million of PowerUp Reward customers on the Sony first-to-know list and 700,000 PowerUp Reward customers on the Microsoft first-to-know list.

Next week, all 4400 of our US store managers will have hands-on training on all of the new games and on the new consoles. So we will continue to be the most knowledgeable source for buying a new console and related games and accessories.

Also, we will have over 4000 of our customers attend our GameStop Expo in Las Vegas next week, where they too will receive hands-on experience with some of the new games and the two new consoles.



Turning to mobile, our business continues its strong performance, generating \$55 million of global revenue, more than doubling over Quarter Two of last year. Our margin on our mobile business was 29% in the second quarter. We are now accepting over 600 SKUs for trade in our stores, and these expanded SKUs are improving our inventory levels.

Also, we recently launched the new Nexus 7 tablet and our exclusive Sophix 8-inch tablet, and both are seeing strong demand. We will also be adding the Samsung Galaxy TAB 3 line later this month.

We fully expect our mobile sales to benefit from the large increase in traffic that we expect in our stores during the third and fourth quarter. And so we are reconfirming our full-year growth targets of between 30% to 40% over 2012.

Digital revenue increased 18% during the quarter as expected, with the US digital business growing 12% and the international digital business growing 43%. International growth was driven by the rollout of digital Game Informer, Steam Wallet, and DLC in traditional markets. By segment, console digital grew 5%, outpacing physical software growth by 25 points during the quarter; and PC digital grew 38%, as we rolled over the successful launch of Mine Craft in the second quarter of 2012.

As nearly every major launch title during the back half of the year is launching with DLC, we expect to continue to outpace the significant software growth that we will see in the back half of the year. And we are reconfirming our full-year guidance of 25% to 35%. Kongregate continued its impressive growth streak with 50% growth. In addition, they launched their first two mobile games, Tyrant and Sheep Happens, on the iOS platform and have many more games in their publishing pipeline as they leverage their \$10 million development fund.

Steam Wallet sales continued their strong trajectory, tripling globally during the quarter, as we have now completed our global rollout of this service. Even in the US, Steam Wallet revenues nearly doubled over last year's second quarter. And Game Informer is the largest digital magazine in the world, with 3.3 million subscribers.

Based on our forecasts, we will have a combined mobile and digital business that exceeds \$1 billion on a non-GAAP basis in 2013. I would like to remind you that these are businesses that we were not in three years ago.

In short, we are ready and excited for the software, digital, mobile, and console launches that lay in front of that -- out in front of us. With that, I will turn the call over to Mike Mauler.

Mike Mauler - GameStop Corp. - EVP GameStop International

Thanks, Tony. Good morning, everyone. In the second quarter, our international same-store sales declined 11.6% versus Q2 of 2012, with results varying by segment. While sales were challenging, we saw a major increase in pre-order activity during the quarter. International reservations increased significantly over the second quarter of 2012. Driven by consumer excitement around the upcoming console launches and outstanding new releases. This reservation growth was a direct result of GameStop's global merchandising teams coordinating with our publishing partners to develop exciting exclusive content and create innovative trade-in promotions, which helped drive the significant increase in reservations for the back half of 2013.

The success of these efforts was a 14% increase in trades during the quarter as customers took advantage of GameStop's buy/sell trade model to secure reservations at an unprecedented rate. This increase in trades provides us with significantly more pre-owned inventory heading into Q3.

During the quarter, we continued to expand and improve the flexibility of our buy/sell trade model. We expanded our multi-channel capabilities, introducing Web-in-store to new markets and launching GameStop's digital wallet in Italy and Germany. Through our loyalty program, the GameStop digital wallet gives our loyalty members the flexibility to use their trade credits both in-store and online to make e-commerce purchases of games, systems, digital content, and accessories. This functionality will be expanded to additional markets in the back half of 2013.

Our efforts to increase customer engagement continued to take hold, with loyalty members in Europe now topping four million and Australia above two million members. The increase in loyalty membership in new markets has also driven the global expansion of Digital Game Informer,

where in Europe we now have close to 300,000 subscribers. Our powerful loyalty programs, combined with an active social media plan, allows us to be closer to and engage our customers more effectively than ever before.

The impact of these increased engagements can be clearly seen, for example, in our Australian market, where our consumer show this October in Sydney will draw over 30,000 passionate customers to experience the exciting new releases and new consoles that are coming this fall.

Finally, our investments in technology and approved vendor collaboration increased international digital sales 43% in Q2, compared to the prior-year quarter. This was driven by strong growth in console DLC, the continued increase in the sale of Steam Wallet cards in all markets, and the initiation of Digital Game Informer's subscription sales in Europe.

The improved collaboration with our publishing partners has had a significant impact on our DLC sales. As can be seen with Sony's successful June release, *The Last of Us*, where our international businesses drove an approximate 30% attach rate on the digital season pass at launch.

Working globally with our partners, we have developed powerful launch promotions for the PS4 and Xbox One and all of the outstanding software to be released this fall. These partnerships, as well as our expanded multi-channel capabilities, strong customer engagement, and dominant market share in 13 countries have GameStop well poised to make the upcoming launch of next-generation consoles a tremendous success.

And now I will turn it over to Mike Hogan for his comments.

Mike Hogan - GameStop Corp. - EVP of Strategic Business and Brand Development

Thanks, Mike. My first topic this morning is an updated look at the GameStop market model. This is GameStop's proprietary forecast model for the North American new-console gaming category. Console gaming includes console hardware, console software, and console digital. The model's inputs include external research, information from videogame publishers and console manufacturers, and our own internal data. In total, over 20 external sources are used.

Key factors that drive the model include new console price points, hardware adoption relative to last cycle, software attach rates based on current trends and the prior cycle, historical growth curves from console launches, digital content availability plus attach rates and subscriptions, and projections of future sales of the existing consoles.

Over the past few months, we have gotten a significant amount of additional information regarding the new consoles and their likely impact on the category. We know there will be two new consoles launched in 2013. Exact details on launch dates, available inventory, and new titles are still pending, but the fact of two launches in 2013 is significant.

At one point, there was some concern that console manufacturers might attempt to limit consumers' ability to share, trade, or resell games. And our research demonstrated that that would seriously limit purchase interest in the new consoles. This has since been clearly resolved in favor of the consumer, which is a significant positive for new console demand.

Through our PowerUp Rewards consumer panel, we continue to monitor consumer awareness and purchase-interest for the new console.

Among PowerUp Rewards members, awareness of the PS4 and Xbox One continued to build and is now over 90%. Interest has also risen considerably since the spring.

This high level of interest is further supported by the over two million PowerUp Rewards members that Tony mentioned that signed up for the PS4 and Xbox One First to Know list through PowerUp Rewards. In fact, in our panel research, 66% of PowerUp Rewards members indicate that they expect to be playing on a next-generation console within the next 12 to 18 months. This also is up significantly from the spring.

With this and other information, including year-to-date category performance, we have updated our market model through 2015. Our projections for 2013 are unchanged. We still see category growth in the back half, with the full year showing a decline for 2013 versus 2012.

For 2014, the model's projections have increased slightly since the spring. Based upon this, we reiterate our projected category growth range of plus-20% to plus-30% console category growth for 2014.

The major positive factors are greater detail around the two console launches and the growing consumer excitement. Given that both the PlayStation 4 and Xbox One will launch in 2013, both will have a full-year impact in 2014. Please note that 20% to 30% growth is still potentially conservative. In the first full year of the PS3, which was 2007, Sony hardware and software grew plus-31%; and in the first full year of the Xbox 360, which was 2006, Microsoft hardware and software grew 59%.

The growth continues in 2015. The model projects a second consecutive year of positive growth for the console category in the range of plus-10% to plus-15%. This, too, is consistent with what we saw in the prior generation launches. By 2015, console digital will be nearing \$4 billion, much of which will be sold in stores.

We've been asked a number of times about the performance of the Wii U and how that factors into the model projections. In previous versions of the model, we assumed the success rate for the new 2013 consoles — the Sony and Microsoft consoles at 80% to 85% of prior generation. Based upon what we knew at the time, however, we had modeled the Wii U at a much lower multiple of prior-generation sales for both hardware and software. Thus, we already had very conservative assumptions for the Wii U. And at launch, the Wii U exceeded those expectations. Sales since then have been softer, but the key will be holiday 2013 performance.

It is worth noting that, in our PowerUp Rewards consumer research, the number one reason consumers give for not yet purchasing the Wii U is the limited number of new games for this console. Post [E3], we are excited about the number of new games from Nintendo, and we do see the potential for significantly improved performance this fall and holiday.

As noted previously, this new console success also means good news for the pre-owned business. Several factors to consider here. One is history. We saw in the previous cycle introduction of new consoles, particularly consoles that are not backward-compatible, drives a whole new cycle of consumer trades. Following the prior cycle, GameStop pre-owned business grew to plus-20% in 2007 and plus-27% in 2008.

Second factor is value. Our PowerUp Rewards panel consumer research shows that the greatest single barrier to consumers for buying the new consoles is affordability. We believe the value that GameStop will offer via our trade-in programs will make the new consoles accessible to millions more consumers than would otherwise would be possible.

In fact, our PowerUp consumer panel research shows that consumers will not only trade-in their existing consoles and games. They also plan to trade in a broad array of electronics, including smart phones, tablets, and music players to purchase their new consoles. GameStop's expanded buy/sell trade program will provide many new ways for consumers to fund their new console purchases.

In summary, we anticipate the console category will show positive growth in the back half but still negative for the year. Even with somewhat conservative assumptions around the success of new Sony and Microsoft consoles, the console category should deliver very strong growth of plus-20% to 30% in 2014, followed by strong growth again in 2015. GameStop stores will additionally benefit from increased sales of console digital in our stores.

Second topic I want to cover today is a brief update on PowerUp Rewards. PowerUp Rewards continues to grow and recently passed the 25 million member mark in the US. This base of PowerUp customers now represents nearly one-third of all software sold in the total category in the US. PowerUp continues to attract the heaviest spenders in the category, with an average annual spend of over \$300, which is more than three times the category average. And our database of member libraries continues to grow. And we now have an accurate record of over 453 million products across the membership base. This is an increase of 36% versus the prior year. We are leveraging this data to drive both current and new businesses in a number of ways.

I will now turn it back over to Paul.



Paul Raines - GameStop Corp. - CEO

Thank you, Mike. These are exciting times at GameStop. As you can hear, we know we have lots of work to do between now and the console launches in the fall.

We will now open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Anthony Chukumba, BB&T Capital Markets.

Anthony Chukumba - BB&T Capital Markets - Analyst

I had a couple of questions. For the first one, I'm very interested in the fact that you now are projecting positive comps for the third quarter. This will be the first positive comp in nine quarters, as you said. Obviously, a lot of this is driven by the strong title lineup. But I guess I have two questions. One, how much of that is Grand Theft Auto V? Because a lot of it -- I mean, I guess the majority of the titles you are anniversarying them year over year. I guess the exception is being Disney Infinity and Assassin's Creed Black Flag. But I was just wondering how much of that is being driven by Grand Theft Auto V?

And then, related to that, does that give you even more confidence in the next generation of consoles, given that people are still very excited about buying tentpole titles in -- for this generation?

Paul Raines - GameStop Corp. - CEO

Thanks, Anthony. Thank you for recognizing nine quarters of negative comps. It is a remarkable industry, and it's been a remarkable struggle for us. It has been a very tough cycle, as everybody knows. Rob, do you want to start that off and then go to Tony?

Rob Lloyd - GameStop Corp. - EVP and CFO

Yes, sure. Anthony, I can't clarify exactly what the impact on the comp is for Grand Theft Auto V. But obviously, it's going to be a huge title. I think one other thing I'll note in there is that Battlefield 4 is -- and every other year title from EA and performs much more strongly than the off-year title, which is Medal of Honor. I'll let Tony talk a little bit more about some of the others that we're seeing there also driving that comp.

Tony Bartel - GameStop Corp. - President

Sure. In addition to the three that you mentioned and Battlefield 4, you have SWAP Force, which we see strong reservations for that product. And you have from Warner -- you have Batman Arkham Origins, which is not a (inaudible). Really what we consider to be six very strong titles that really have no roller components. And then you add in the Assassin's Creed flip from our third -- from our fourth-quarter to our third-quarter, gives us strong confidence in the comp guidance.



Anthony Chukumba - *BB&T Capital Markets - Analyst*

Okay. And then the second part of that question was just -- you know, does this give you even more confidence about the next generation? I mean, typically this late in the cycle, I mean, game sales usually just kind of fall off a cliff, right? Because everybody's sort of saving their money for the next console. So I guess I'm just wondering does this make you even more confident?

Paul Raines - *GameStop Corp. - CEO*

I think, guys, and maybe Tony can add to this --. Anthony, the thing that we talk a lot about here is innovation. And there's a big focus on technology, which is important. But innovation is really what drives the consumer in. And so, I look at things like just Infinity last weekend. We were all in stores on Sunday; new customers who haven't been in our stores in a long time coming into look at new [IP]. So I think it does give us confidence, the level of innovation entering -- or re-entering the category is pretty exciting. Fair to say, Tony?

Tony Bartel - *GameStop Corp. - President*

Fair to say. And, again, we've got 2.2 million people that are still not -- that we haven't been able to satisfy with reservations. So you have a lot of people that are very interested in the new consoles. Well, I think it's also interesting to note that when we put out the announcement that you could upgrade from Xbox 360 to Xbox One at \$9.99, we saw a significant acceleration in some of those tentpole titles, which indicates that people are very much planning to buy them for Xbox One. And now we've made it simple to go ahead and buy the Xbox 360 version. So you're seeing an increase in reservations. So I think there is tremendous demand for the tentpole titles. And there's some great ones coming like Titanfall and Destiny, as well, that are ahead of us.

Anthony Chukumba - *BB&T Capital Markets - Analyst*

Okay, that's all very helpful. Congratulations, and good luck with the remainder of the year.

Paul Raines - *GameStop Corp. - CEO*

Thank you, Anthony.

Operator

Colin Sebastian, Robert W Baird.

Colin Sebastian - *Robert W. Baird & Company - Analyst*

Thanks, guys. Another nice job this quarter. First off on the NextGen consoles supplies, is the better visibility on the launch related to overall hardware production and availability, or is this more specifically around your allocation? Because I know there's been some concern about other retailers focusing back on the games category this holiday. And then secondly, Rob, on the operating expenses, you've been controlling that well. I'm curious how much more room for rationalization you see. Or is -- with the ramp of the next-gen, you end up spending a little bit more on marketing and other perhaps store related costs? Thanks.

Paul Raines - *GameStop Corp. - CEO*

You know, one thing, Tony and Mike Mauler are close -- they're daily, practically, to console makers. The one thing I would point out to investors is remember that we are not jumping into this console launch sort of like right now, beginning to think about quantities. We have been at this now through PowerUp Rewards, through our international programs -- we've been at this now for well over a year, planning this launch and communicating



privately with consumers. So these guys will tell you a little bit about what they see on quantities. But what I like about this is we are deeply involved with consumers on an individual level thanks to our loyalty programs well in advance of these launches. Tony?

Tony Bartel - GameStop Corp. - President

Yes, and I don't have visibility to what the -- obviously to what the other retailers are getting. So I can't determine what our share is of the allocated quantities. And I really don't want to share, for competitive reasons, what our increases are. But suffice it to say, as Ron said earlier, it is above what we had originally forecasted. So clearly, they are exceeding our expectations from a launch standpoint.

And I think they also understand that launching at GameStop, you have the affordability of buy/sell/trade, which is why you are seeing some of those programs come out. And they also understand that our attach rate of titles and accessories is going to be higher than our competition.

Paul Raines - GameStop Corp. - CEO

You want to talk about the international?

Mike Mauler - GameStop Corp. - EVP GameStop International

Sure. I think internationally we are seeing much stronger reservations as well, compared to the last cycle. And it's really driven by a couple of factors. I mean, the excitement around the consoles itself. But also really strong uses of our loyalty programs in the markets where we have a loyalty program and we have a large number of members. But also very strong trade-in promotions. And we saw customers take advantage of that in Q2, taking the ability to trade in their old games or old consoles and be able to afford the next-gen console. And that drove a lot of reservations for us.

Paul Raines - GameStop Corp. - CEO

Bob, do you want to -- that second piece?

Rob Lloyd - GameStop Corp. - EVP and CFO

Sure. You know, we continue to focus on how we're spending money. And, as we talked about earlier, we were able to reduce our SG&A in the second quarter from last year. And I think as we look ahead, we'll continue to focus on it, we'll continue to come up with new programs that allow us to do that. But as we said before, there is no better time to leverage your SG&A than during the console launch cycle.

The amount of hardware that you move through the store and the size of the transaction really allows us to gain leverage off of the payroll costs and the fixed costs in the stores.

Paul Raines - GameStop Corp. - CEO

One of the things -- you know, Colin, and you know this and many investors who followed us for a while know this. We had to make a series of foundational investments, you know, through 2010 and early 2011. Top among those was PowerUp Rewards. We had to build out technology, all the things that we did. In many ways, that asset now is going to be leveraged across these launches, just as it was leveraged in the launch of the mobile business, the launch of the DLC business. All of these are acquiring customers via that big asset that we spent the money on.

So as we said, I think it was a couple of years ago on our year-ending call, the goal was to build those assets and then hold SG&A and lever them across the future launches. So that's what you're seeing, I think.



Colin Sebastian - *Robert W. Baird & Company - Analyst*

Paul, maybe as one quick follow-up, then. You announced this Simply Mac investment. Is there a plan there to make incremental investments in that business, or is this something perhaps where you can convert some of the GameStop stores that you close into another format? Or how should we think about that investment going forward?

Paul Raines - *GameStop Corp. - CEO*

Yes, that's a good question, Colin. I think, you know, we have a high rate of sort of intellectual curiosity; we're trying to drive a high rate of change. Simply Mac is a premier authorized reseller of Apple products and services, with 12 or 13 stores in Utah, Colorado, Wyoming, and now in Texas. And the goal here -- we met them and became acquainted with them. We're a minority owner of that business. Steve Bain is the President and CEO and founder of that business. And Steve and his team from Salt Lake City do a great job of providing an Apple experience with great support from Apple in secondary markets. So towns like -- we just opened in Midland, Texas; we are open now in Tyler, Texas; Fort Collins, Colorado; and different towns that of that kind. Secondary markets that don't have great access to that high-quality Apple service. That's where Simply Mac is.

If you look at what we bring to the party, we bring common platforms. Real estate, we are one of the -- certainly in specialty retail, we're one of the strongest teams in the United States. If you look at our talent sourcing organization and the human resources area, we have tremendous access to talent and staffing. And of course, buy/sell/trade, we bring a significant capacity. So I think you're right. If you look at the things we do -- we also have that BuyMyTronics store here in Dallas and in the Bronx. That is a similar case where we are leveraging. So the idea is that we have built common platforms and competencies. And what other electronics categories can we bring to them? And that's what Simply Mac is all about. And we are very happy with where we are at there.

Colin Sebastian - *Robert W. Baird & Company - Analyst*

Thanks, guys.

Operator

Curtis Nagle, Bank of America Merrill Lynch.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Good morning, and congrats again on a very nice quarter. Just a couple of quick questions. I was just wondering what kind of demand you guys were seeing for accessories for the new consoles in the pre-order? The pre-orders that you've gotten to date. If you could elaborate on that a little bit.

Paul Raines - *GameStop Corp. - CEO*

Yes, Tony do you want to talk about accessories?

Tony Bartel - *GameStop Corp. - President*

Sure, we have a high success rate attach rate of the accessories we know about, but they are rolling out. So we'll continue to roll out accessories.

Here's the beauty, though, of our system. Curtis, that every time that we take a reservation, typically for the PowerUp Rewards members --. So we already have a relationship; even if it's not, we have a way of contacting them. So as these come out, in real-time we're talking to our customers

about them. And, you know, these new systems are very innovative and they are going to require additional accessories. So our people next week are going to go through one day of training each on the Xbox One and the PS4 so they know exactly how to guide customers. They hear everything you are going to need to put underneath the tree or to play immediately so that you have a great experience.

Paul Raines - GameStop Corp. - CEO

I think one of the things that is an emerging trend for us, Curtis, is that we have a very significant Web-in-store capability. Because of our small footprint, because of our limited ability to stock a lot of inventory, you see us offering accessories more and more through a Web-in-store process. That has become very meaningful for us. And Tony and Mike; and Bob Puzan, who runs our merchandising; and Michael Vanderberg, who runs the international merchandising -- when they sit down with a publisher, they're able to bring the publisher more and more ideas around accessories, right? And these are accessories that we don't have to push through our supply chain. We can offer them in-store visually or add them at POS and ship directly to the consumer. So that whole world of accessories is going to get -- is going to change significantly in this platform launch.

Curtis Nagle - BofA Merrill Lynch - Analyst

Great, that's very helpful. Thank you. And then just the other question I had was -- and I was just curious how you guys were thinking about the current generation of systems, the Xbox 360 and the PS3, kind of going after, I guess, the launch of the new consoles. And how do you see GameStop positioned with them, kind of versus peers?

Paul Raines - GameStop Corp. - CEO

I think Mike Hogan had some data on that. Mike, do you want to share that on the last consoles?

Mike Hogan - GameStop Corp. - EVP of Strategic Business and Brand Development

Yes, sure. So your question is what happens to the existing systems once the new systems are launched?

Curtis Nagle - BofA Merrill Lynch - Analyst

Yes.

Mike Hogan - GameStop Corp. - EVP of Strategic Business and Brand Development

We certainly expect Sony and Microsoft to continue production. Much like happened with Sony in the CS2. The best piece of data I can give you here is that 61% of the PS2 units that were sold, life to date, were sold after the PS3 was announced. So we would expect that there would continue to be a robust market for each of those products following the launch this fall.

Curtis Nagle - BofA Merrill Lynch - Analyst

Fantastic. Well, again thanks for that clarification.

Paul Raines - GameStop Corp. - CEO

Thank you, Curtis.



Operator

Brian Nagel, Oppenheimer.

Brian Nagel - Oppenheimer & Co. - Analyst

Congratulations on a nice quarter. First question I have is maybe go back to one -- is going to be a follow-on to one of the prior questions. But I just wanted to understand better this current demand dynamic.

You look at -- so Q3, your indicated sales should take up significantly on better sales of software to existing the devices. But at the same time, we've seen really strong initial demand for the new console. So the question I have is you look at your power rewards data -- and the customers are signing up for both the softwares and hardwares -- is it two distinct groups of gamers? Or is it indications that maybe the gaming community is going to operate on both the older systems and the newer systems going forward?

Paul Raines - GameStop Corp. - CEO

Mike, what kind of insights do you have on that? Do you have any data surrounding sort of people's multi-console behavior?

Mike Hogan - GameStop Corp. - EVP of Strategic Business and Brand Development

Yes, I mean, there's a lot of things we could tell you. First is that well over half of the people that we have in our database are multi-console owners today. And we certainly expect that as people move to new consoles, obviously some of those people are going to trade in the existing consoles. But that also means that there's other people that are going to come into the category through the pre-owned business, particularly as it becomes a really affordable option.

I think I would also take you back to Tony's comments about the First to Know list and the demand that we are seeing today for the consoles. I mean, our biggest challenge is going to be getting enough product to keep up with the demand that's there. So we're going to obviously be able to move every console that we can get our hands on. But there's the vast majority of the market is still going to be people who are still in the existing consoles, and we'll have tremendous amount of people coming and buying games for those consoles.

Paul Raines - GameStop Corp. - CEO

And Brian, the other issue that was in Tony's remarks or Mike's remarks was the affordability issue. GameStop is just uniquely positioned on this affordability dimension. You know, we compete on the value dimension, we compete based off of trades. We don't compete based off of discounting. And our ability -- and this is one of the reasons, frankly, that we expanded the universe of trade and recommerce into electronics a couple of years ago. Because we saw consoles coming a couple of years out and said, how do we create more value for consumers so we can take smart phones and tablets and so forth. So this innovation-versus-affordability question, I think, is what will play out here and define how much consumer adoption we get on the consoles.

Brian Nagel - Oppenheimer & Co. - Analyst

Got it. That's helpful. And then maybe that could work as a decent segueway into the follow-up question I had. As you have been talking, it looks like the -- you mentioned the allocations of the new hardware devices in your press release and your comments today. You know, it seems like production numbers maybe could be up higher than in prior cycles.



So as you are talking to the Sonys and Microsofts of the world, is there any indication you're getting that -- maybe not just only the initial launch but through that first year, you're going to see much better shipment-type numbers?

Paul Raines - *GameStop Corp. - CEO*

What do you think, Tony?

Tony Bartel - *GameStop Corp. - President*

I think there's a lot of optimism that that will be the case. That being said, it's very early in the production cycle. And so I think that we are getting definite desire from the publishers that that would be the -- or the platform holders that that would be the case. And I think it all depends on the yields as they begin to produce these products. But, again, based on Rob's comments earlier, what we have received in terms of allocations from the launch quantity we would assume through the balance; at least our fiscal, they did exceed our expectations.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Thank you.

Paul Raines - *GameStop Corp. - CEO*

Thank you, Brian.

Operator

Arvind Bhatia, Sterne, Agee.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Thank you. I'd like to add my congratulations, guys. A question on the market model. The plus-20% to plus-30% in 2014, I was hoping you could maybe provide a little bit more color how that kind of breaks down between hardware and software, even though it's very general or directional. And then also, I want to be sure I got this right that in 2015, you have increased your growth assumptions to 10% to 15%, and previously it was 8% to 12%. Are those apples to apples numbers? Thank you.

Paul Raines - *GameStop Corp. - CEO*

Mike?

Mike Hogan - *GameStop Corp. - EVP of Strategic Business and Brand Development*

Sure, so as far as the total model, the 20%, 30%. You know, what's included in that number is the console hardware, console software, console digital. And I don't believe we've broken that down by components, but within that.

As far as your question about 2015, the numbers that we showed last time, the [10] to [12] was the number that was -- just included console hardware and software. We expected console digital to grow at a higher rate than that, and that's what drives the higher range in here. So the



range we're giving you there is apples to apples, with [14] in the console category including console hardware, console software, and console digital.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Okay. And then just a small question, I guess, on the hardware margins this quarter being higher than normal. Is there anything going on there that we should be aware of?

Paul Raines - *GameStop Corp. - CEO*

Rob?

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

I know it was like [10-point] -- almost 11%. Usually it's around 8%. Anything unique there?

Rob Lloyd - *GameStop Corp. - EVP and CFO*

Yes, hardware margins and software margins as well can move around from quarter to quarter based upon what we're doing in terms of selling extended warranties. It also has to do with the kind of cooperative advertising dollars we're getting from our publishing and console partners. And so I wouldn't say there's anything more going on there than what's normal.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Okay. And then last quick one for me. You are seeing a lot of success with Infinity. You've done really well with titles like Skylanders. I assume that you're going to come back with a GameStop Kids store concept again this holiday. If yes, what are the plans in terms of how many you'll be opening?

Paul Raines - *GameStop Corp. - CEO*

Well, Arvind, we don't disclose those kinds of things. As you know, competitors are eager to know what our plans are. We are excited about Infinity and kids, and Tony knows exactly which SKUs he needs to go order more of. Right, Tony? We know (multiple speakers) Infinity; we have a lot of insight. I think we're still planning what we do here, Arvind, in terms of holidays. So nothing disclosed at this time.

Tony Bartel - *GameStop Corp. - President*

Rest assured that it will be given more space in our stores during the holiday. So there will be a kid section in every one of our stores.

Paul Raines - *GameStop Corp. - CEO*

The intersection, you know -- we had, I think two or three calls ago, the intersection of toys and software. And toys and games is an interesting space for us. Our challenge, of course, is the physical space in the stores. So that's what -- the battle we fight every day is that one. Our service levels are superior to everybody else, but our challenge is always space. So that's the battle we fight, and that's why see us do things like the GameStop Kids last year.



Tony Bartel - GameStop Corp. - President

And the biggest thing that we offer on Infinity is instead of having people having to run all over town trying to figure where there characters are, we allow them to reserve all of the characters at our stores and come pick them up, which is a great benefit and which is the main reason why were able to exceed our expectations on that launch.

Arvind Bhatia - Sterne, Agee & Leach, Inc. - Analyst

That's great. Thank you, guys. Appreciate it.

Operator

Seth Sigman, Credit Suisse.

Seth Sigman - Credit Suisse - Analyst

Okay, thank you. There was a comment earlier that pre-owned trade activity has started to increase, and there may be better pre-owned inventory now hitting the shelves. What's been the consumers' response -- that used games customer. What's been their response? And would you be expecting used game sales to accelerate at some point? And I guess it makes sense that consumers will trade in their own stuff, but just trying to understand the level of confidence that there's a segment of the market that still may be interested in those last-generation used products. Thanks.

Paul Raines - GameStop Corp. - CEO

Maybe Mike Hogan, you can start that. And then Mike Mauler has some comments on that.

Mike Hogan - GameStop Corp. - EVP of Strategic Business and Brand Development

Yes, sure. I think, again, the best data we can give you here is history from the last console cycle. Certainly, we do expect to see an increase in trades. Because not only do you have the innovation of new consoles, but there are consoles that won't be backward-compatible. We've got some, obviously, some great value offers for consumers to trade up whether they're buying the current generation and going to the next one. If you look at the history we had last time, the pre-owned business grew dramatically in the first two years following the launch of the PS3 and the Wii. It grew 20%, followed by 27%. So we are being very aggressive about trades. We always like to increase our pre-owned inventories. And that's because we would have very high expectations for our pre-owned business next year following the launch of the consoles.

Paul Raines - GameStop Corp. - CEO

Mike Mauler?

Mike Mauler - GameStop Corp. - EVP GameStop International

Sure. I think one of the drivers that was what we saw in Europe was, this time versus the last console cycle, we had very strong promotions on the reservation programs for the new consoles and some of the key new releases. So what we saw in the second quarter was a 14% increase in trades, as consumers traded product in in order to secure those new console reservations. And so that does have us ending Q2 with higher used inventory than we did last year.

Seth Sigman - *Credit Suisse - Analyst*

Okay. Thank you. That's helpful. And just a follow-up question on the gross margins. I guess first, how do you think about the margin profile of some of the next-generation products? And then related to that, from a mix perspective, I know in the first couple of years you typically see some overall margin compression. But you have some other drivers there today between digital and just greater use penetration than maybe a few years ago. So how do you think about margins and how those drivers can maybe offset the mix of hardware? Thanks.

Rob Lloyd - *GameStop Corp. - EVP and CFO*

Seth, this is Rob. We're very proud of the fact that we expanded our gross margin by 400 basis points since the peak of the business in 2008. And a part of that is the mix of product that you sell when the console cycle is on a downward trend. So the expectation would be that you're going to sell a lot more hardware, you going to put some more pressure on those margins. So we've talked about them being comparable for 2013. But as we move into 2014, I think that you can expect the margin rate to come down a bit. The good news is the businesses that we built digital and mobile, and the rollout of best practices on pre-owned throughout the world and the improvements we've seen there, will prevent it from going back as far as it was in 2008. So it will come down some, but not nearly to where it was.

Seth Sigman - *Credit Suisse - Analyst*

Okay, that's great. Thank you for the color and good luck.

Paul Raines - *GameStop Corp. - CEO*

With that, we will wrap up the call. And I want to thank all of you for joining the call. Thank you for your support of GameStop. We believe that ours continues to be a compelling story and a great investment. Goodbye.

Operator

And that does conclude our conference. Thank you for your participation.

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