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GME - Q4 2014 GameStop Corp Earnings Call

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OVERVIEW:

Co. reported FY14 YoverY sales growth of 2.8%. Expects FY15 revenue to range between down 1% and positive 4% and EPS to be $3.60-3.80. Expects 1Q15 total revenue to range from negative 2% to positive 1% and EPS to be $0.53-0.60.

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CORPORATE PARTICIPANTS

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Tony Bartel *GameStop Corporation - COO*

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PRESENTATION

Operator

Good day, and welcome to GameStop Corporation's fourth-quarter and full-year 2014 earnings conference call. A supplemental slide presentation is available at Investor. GameStop.com.

(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 the property of GameStop. It is not for rebroadcast or use by any other party, without the prior written consent of GameStop. At this time, I would like to turn the call over to Paul Raines, Chief Executive Officer of GameStop Corporation. Please go ahead, sir.

Paul Raines - *GameStop Corporation - CEO*

Thank you, operator, and welcome to the year-ending earnings call for GameStop. As we begin our call, I as always, want to thank our global team for delivering outstanding customer service in 2014. Joining me today on our call are Rob Lloyd, Chief Financial Officer; Tony Bartel, Chief Operating Officer; Mike Mauler, President of International; Mike Hogan, our EVP of Strategic Business and Brand Development; and Matt Hodges, our Vice President of Investor Relations.

In 2014, we saw many aspects of our strategic plan come to fruition, and I am very proud of the dedication and execution of our entire team. One of our goals was to maximize our brick and mortar stores, and our next-gen video game hardware and software launches were dominant, as we delivered an all-time high market share of 28% on hardware and 46% on software.

All the investment in PowerUp Rewards' unique content, execution, and customer service paid off with this generation. We expect that to continue. Non-GAAP digital receipts climbed 31% year over year, and digital is a solid growth story for us.

We delivered this year $948 million of digital revenues. If you go back and look at our 2010 investor day, we forecast $1.5 billion by 2015, and though we will not reach that target, our growth is comparable or ahead of most publishers. Rob will discuss our digital market share and our progress in that business with you.

Pre-owned showed growth of 2.6% in a declining software market, and maintained healthy margins. You will recall that last year, we introduced the value category as our strategy to gain share in new games sold below $20, as well as growing our pre-owned category.

I am pleased to report that our market share in this category grew by 2%, indicating that our buying took inventory out of the market and away from our competitors. Let me state once again that competitors who have entered the pre-owned market have not hurt our market-leading position, but have helped create greater awareness among consumers.

Technology Brands had a spectacular year. On this strategy, I am pleased to report that we have exceeded our initial commitments laid out last year. After only two years, our Technology Brands strategy is producing real results, and we now expect that business to contribute over $1.4 billion in sales and $170 million in operating earnings by 2019.

Our internal rate of return on acquisitions and new real estate exceeds our internal targets, and we believe we are the most productive dealer for both AT&T and Apple. Our partnership with AT&T is particularly productive. After only two years, we are their second largest and fastest-growing dealer, and we have done multiple acquisitions in the past year.

Our Cricket stores are also growing, although not as fast. Even our GameStop Technology Institute in Austin is partnered with AT&T on high-speed fiber connections, as you may have read about in the AT&T annual report.

Apple is also a great partner, and with the three acquisitions we have made, we are now the largest independent dealer. We believe there is a solid business model to place Simply Mac stores in secondary markets that do not have Apple retail, and take share from existing big boxes.

The end result of all this activity is a record high gross margin rate of 29.9%. In the last seven years, we have increased our gross margin rate from 25.8% to 29.9%.

As many of you know, we recently completed our third investor survey in the last five years. One of the points of feedback that we got in that survey is that we need to set achievable financial targets. Rob will cover our guidance with you, but I wanted to point out in that spirit, that given the way this console cycle has played out, modeling software growth has been challenging.

For 2015, we have looked at every model available from analysts, software publishers, and industry sources. Analyzing of all this information and comparing it with our internal data, our team has forecast our new software growth for 2015 at 4% to 6%, a number we believe to be realistic for our business.

The final pillar of our strategic plan is disciplined capital allocation. Outside of any investment opportunities that are more accretive than buybacks, we intend to return our free cash to shareholders. During 2014, we repurchased $333 million of stock, and paid out $149 million in dividends. We currently have an authorization of $500 million on our share repurchase plan, and we recently increased our dividend by 9% to $1.44 per share.

As we look ahead to the future, we are excited. Our video game business has a solid growth rate, and we have been successful in building our market share, loyalty programs, and reputation, which will serve as a springboard for our future growth. Our digital and Tech Brands initiatives give us great growth vehicles, and our pre-owned business will always be a strong foundation.

Before I turn it over to the team, I want to make one important point. At GameStop, only one thing remains constant; our focus on the ongoing transformation of the Company.

At the heart of GameStop's evolution is the story of driving commitment to change, the relentless pursuit of innovation, and a deep understanding of the consumer marketplace. One good example of our ongoing transformation is that non-physical gaming products will represent 20% of our revenues this year. Mike Hogan has been running our business development process for several years, and we have asked him to discuss this topic later in the call. Thank you for your support at GameStop, and I will pass the call on to Rob.

Rob Lloyd - *GameStop Corporation - CFO*

Thank you, Paul. Good afternoon. Today, I'd like to take you through four major points.

First, I will very briefly recap our results for FY14. Next I'd like to discuss our 2015 guidance, focusing on software growth. Third, I'll provide some information about digital, from both a market and a GameStop perspective. And lastly I will provide additional color and metrics on our Technology Brands segment.

So let's begin with the 2014 recap on slide 2. Overall results were in line with our expectations. Sales decreased 5.6% in the fourth quarter, but increased 2.8% for the year. Excluding FX, sales decreased 2.8% in the fourth quarter, and increased 4.3% for the year.

Comparable sales declined 1.8% for the quarter, but increased 3.4% for the year. Gross margins expanded 50 basis points for the year, resulting in a 29.9% margin rate, which is our highest annual gross margin rate, and the highest gross profit dollars we have achieved in our history. Operating earnings increased 7.7% for the quarter, and increased 7.8% for the year.

Non-GAAP net income increased 5.9% for the quarter and 10.2% for the year. Non-GAAP EPS increased 13.2% for the quarter, despite a $0.05 negative impact from FX rates and increased 15.3% for the year, despite an $0.08 negative impact from FX. SG&A as a percentage of sales was 21.6% for the year, up from 21% the prior year, due to the growth of Tech Brands, which carries a higher SG&A rate.

Now let's look at sales for some of the categories on slide 3. As expected, hardware declined 30.2% in the quarter, with a tough comp, given the console launches in the same period last year, but hardware grew 17.3% for the year. Software grew 6.1% in the fourth quarter, but was down 11.3% for the year. We're now seeing next-gen software consistently exceed prior-gen on a monthly basis, and it's great to note that we ended the year with our highest market share ever in hardware and software.

Pre-owned revenue was down 1.7% in the quarter, but increased 1%, excluding currency. Pre-owned revenue grew 2.6% for the year, despite the decline in new software, and the effect of currency headwinds. Pre-owned margin rates for the quarter were comparable to the prior year, and the full year were up 100 basis points from 2013.

As we close the fiscal year, we made an adjustment to GAAP digital revenues to convert Kongregate's Kreds and mobile revenue from a gross to a commission basis, with an impact of approximately $15 million. We closed a net of 251 video game stores around the world. We acquired or opened 266 Technology Brands stores.

In 2014, we repurchased $333 million in stock or 8.4 million shares at an average price of $39.50, and we paid out $149 million in dividends. We generated free cash flow of $334 million, which was below our guidance range, due primarily to the timing of payments associated with income taxes and other liabilities, of approximately $60 million when comparing FY14 to FY13. We also had increases in accounts receivable, associated with the Tech Brands business, of approximately $20 million.

The last thing I'd like to cover on 2014 is how the market performed relative to industry projections. As you can see on slide 4, in 2014, the North American physical and digital console market was expected to total approximately $16.7 billion, implying about 13% growth over 2013. Hardware exceeded expectations by about $500 million, due to strong next-gen sales. Physical software fell short of expectations by about $800 million, which as you can see is entirely due to the throw off of the old-gen. And digital fell a little short of growth expectations.

In total the console market grew 9% to $16 billion, versus the 13% increase that had been predicted. What's important to note here is that the shortfall in physical software was caused by the falloff in old-gen software sales but was not caused by a greater than expected shift to digital, which came in below industry expectations.

Now, I'll move on to 2015 guidance. As stated in our earnings release, we are guiding the EPS ranging from $3.60 to $3.80 per share for 2015, an increase of between 3% and 10%. Full-year revenues are forecast to range between down 1% and positive 4%, with same-store sales ranging from positive 1% to 6%. We anticipate a foreign currency exchange impact of approximately $300 million to $400 million in sales, and between $0.06 and $0.09 per share for FY15.

Looking at the first quarter of 2015, we expect total revenues to range from negative 2% to positive 1%, and same-store sales of positive 2.5% to 5.5%. We expect earnings per share to be in the range between $0.53 and $0.60 per share.

For purposes of your models, the average number of shares outstanding when used in our guidance is 109 million shares for the first quarter and the full year, as we do not assume any share buyback in our guidance. This is 2 million shares more than the consensus models, and that has an impact of approximately $0.07 per share for the year. We project free cash flow for FY15 to range between $400 million and $500 million, with the largest variable being the number of Technology Brands stores, and the CapEx and receivables to support that.

The next slide shows you the major puts and takes of sales in 2015. Foreign currency exchange impacts could essentially wipe out all of our comp store sales gains expected for the year. Let me go off the slide for a minute.

We've compared our revenue expectations by category for 2015 to the average of the analysts models. We're fairly consistent, with the exception of new software growth. We are estimating new software growth in 2015 to be between 4% and 6%, based on our current visibility into the title line-up.

The consensus estimate for new software growth is over 11%, which we believe is overly optimistic. Last year, we shared with you our projection that the console market would grow 10% to 15% in 2015. The decline in old-gen software in 2014 occurred faster than we or the market expected, and following those results, we project declines in old-gen hardware and software of more than 50% in 2015. We see moderate growth in new-gen hardware, over 50% growth in new-gen software, and growth in digital of more than 10%.

Moving on to some greater depth on digital. Based on all of the sources we have used over the last couple of years to build the market model, we believe DFC intelligence is the leading third-party resource in the console digital space. This spring, DFC will be publishing some insightful data on what happened in the digital market in 2014.

We have some of that data that we can reveal today. The number-one digital component to address is the adoption rate of full game downloads. Slide 7 shows some key statistics based on DFC data, which analyzes the AAA games sold in 2014.

You can see that DFC estimates that of the total number of AAA video games sold last year, 12% were downloaded, and 88% were physical. Of the 12% downloaded, it is estimated that 60% were given away in hardware bundles. That means about 5% of AAA titles were downloads, but were actually paid for by consumers.

DFC estimates that full game downloads of AAA titles paid for by consumers made up only 2% of the total physical and digital software market. DFC also provided us some data on their estimates of the DLC market for 2014. Overlaying our DLC sales on to DFC's estimate of market sales, we calculate that we had approximately 42% of the market, in line with our overall software share. Hopefully on our next call, we can take DFC's published data and our data and provide even greater clarity.

Now, let's move onto a discussion about Technology Brands. Slide 8 shows our performance in Technology Brands for FY14. As you can see, revenues totaled $329 million. Operating earnings were $33 million, with an operating margin of 10%.

Tech Brands added $0.19 to earnings per share. We believe this was an incredibly successful first full year, with 5% of our consolidated operating margin coming from a new segment.

The next slide shows the average internal rate of return target for the Tech Brand stores we opened or acquired in 2014. As you can see, we acquired 16 dealers with a combined targeted IRR of 23%. We opened 123 whitespace stores, with the combined IRR of 27%.

Between acquisitions and new stores, our aggregate targeted IRR is 24%. As we seek new whitespace stores or new acquisitions, the minimum targeted hurdle rate is 20%. Keep in mind, our weighted average cost of capital is 10.6%. As I have said in the past, our targeted IRR is far in excess of our weighted average cost of capital.

The potential RadioShack stores which we are negotiating have a pro forma IRR of 25%. The performance of our new and acquired Tech Brand stores in 2014 was very strong, as they outperformed their pro formas by 114%. This is due to our ability to drive productivity and customer conversions, particularly in stores we acquire from other resellers. We're projecting growth of 350 to 550 Technology Brands stores in 2015, to include whitespace stores, acquisitions, and conversion of GameStop stores.

The last slide provides updated guidance on where we see the Tech Brands business growing in the next five years. As you can see, and as Paul mentioned, we believe we can grow this business to over $1.4 billion in revenues by the end of 2019, and almost $170 million in operating earnings. The CAGRs demonstrate robust growth for several years. I will now turn it over to Tony for his comments.

Tony Bartel - *GameStop Corporation - COO*

Thanks, Rob. Good afternoon. This is a very exciting time for GameStop at this stage of the console cycle, as we continue to dominate the video game market around the world, grow our differentiated position and market share, and branch into exciting areas that leverage our retail and digital expertise.

The focus of my comments today will be on the current console software environment, our plans to continue growth in our digital business, and the expansion of Technology Brands. To date, this has been a strong launch, and GameStop has gained on every front as compared to the last launch. The PS4 Xbox One category hardware unit sales are 56% higher than PS3 Xbox 360 over the same period of time following the launch. GameStop has gained significant hardware share, with our unit sales up 145%.

In software, we have a commanding 46% market share of PS4 Xbox One software, with unit sales up 92% over the last launch cycle, and so far in 2015, we continue to dominate the new generation of software, with our Xbox One and PS4 software market share at 52%, up 440 basis points over the same timeframe in 2014. We believe that new software sales were impacted in the latter part of 2014, as many games were given away as subsidized marketing incentives, in next-generation hardware bundles.

According to NPD, these free digital games reduced the total physical next-generation software market by $250 million. We also believe, based on our discussions with publishers and platform holders, that these pack-in programs will be significantly reduced in 2015.

We're excited about the innovation that is coming to the new consoles in 2015. Key titles include the just-launched Battlefield Hardline from Electronic Arts, the soon-to-be launched Mortal Kombat X, and Batman: Arkham Knight from Warner Brothers. Madden, FIFA, and Star Wars Battlefront from Electronic Arts, Halo 5 from Microsoft, and Call of Duty's next installment from Activision.

We leverage our close relationship with the publishers to drive differentiation. For instance, two weeks ago, we had a very successful launch of Battlefield Hardline. Working closely with EA, we provided each US associate with the opportunity to play the actual game four days prior to its launch.

They were able to share their experience through both social media and with our customers during the weekend, and during the crucial midnight opening. Clearly, we had the most informed associates on the night of the launch.

In terms of our pre-owned business, they returned to growth in 2014, and we expect it to accelerate in 2015, driven by new software growth. As the next-gen cycle takes hold, we're seeing more of our pre-owned sales shift into PS4 and Xbox One. Additionally, as publishers continue to transition from legacy to new, it positions GameStop as the destination location for older games and systems.

In addition, we continue to drive new forms of payment to make GameStop the most simple and affordable place for gamers' favorite technology. In addition to the PowerUp Rewards credit card, which has generated over $225 million of credit so far, we've also added Apple Pay and a gift card exchange program, to provide customers with even more ways to afford the technology that they want.

Turning to our digital business, we matched the growth of our publishing partners by generating $948 million of digital receipts at a growth rate of 31%. Key digital drivers continue to be our dominant share of downloadable content, digital sales of full game downloads, our sale of subscriptions and points cards, digital Game Informer, and our fast-growing Steam PC download business.

Our important role in the digital value chain is the discovery and affordability of digital content. And we have spoken often of our success in driving digital adoption with our customers. As Rob mentioned, based on data from DFC Intelligence, we had a 42% market share in 2014 of all of the downloadable add-on content sold. We accomplished this because our knowledgeable associates, many of whom have actually played the downloadable add-on content, helped customers discover and purchase this great content.

We expect to provide similar benefit for full game downloads, both for AAA games and for indie games. We are a key player in the digital value chain, and we have plans in place to be full participants in all facets of digital gaming, similar to what we have done in add-on downloadable content. And in mobile, our Kongregate service continues to publish profitable mobile games. We expect to publish 15 to 20 games this year, and grow our mobile revenue by 80%.

It's important to note that two of our most important digital initiatives, our mobile and PC publishing and our digital magazine, Game Informer, are led by two of the most influential women in gaming. Emily Greer, the Cofounder of Kongregate, and Cathy Preston, the Publisher of Game Informer.

Finally, as Rob shared, we are very pleased with the returns that we're getting on our Technology Brands businesses. We have close exclusive relationships with AT&T and Apple that allow us to participate in consumer-friendly offerings such as the next program in our Spring Mobile stores, and iPhone warranty replacement in our Simply Mac stores. These partners also offset a portion of our construction costs.

The growth of 350 to 550 stores that Rob talked about will come from four main sources. First, whitespace development. Working with AT&T and Apple, we have identified sites that will support a new AT&T, Cricket, or Simply Mac store, and we're leveraging our real estate and expertise to identify and procure the best real estate available.

Second, mergers and acquisitions. Working closely with our partners, we continue to look at opportunities to acquire new stores. On average, we see at least a 30% increase in productivity in acquired stores through stronger execution.

Third, GameStop real estate conversions. As we continue to rationalize the GameStop asset base, we are identifying locations where we can convert GameStop real estate into AT&T, Cricket, or Simply Mac locations. We target stores that we can transfer significant sales to nearby GameStop locations. This is our most profitable asset move, and we plan on executing 70 to 100 of these conversions this year.

Finally, RadioShack conversions. We procured 163 leases from the RadioShack bankruptcy trust, and we're currently in the process of converting most of these leases into AT&T stores. We were very selective in picking the top stores that had great lease terms, strong visibility, and were consistent with our partners' needs. With that, I'll turn it over to Mike Hogan for his comments.

Mike Hogan - *GameStop Corporation - EVP Strategic Business & Brand Development*

Thanks Tony, and good afternoon everyone. Paul asked me to comment briefly on our business development process, and the areas in which we continue to explore new growth opportunities. We initiated a robust business development process a number of years ago, to facilitate our diversification efforts.

We are constantly exploring new prospects that could leverage core GameStop capabilities to drive future growth and value. GameStop has been the unquestioned leader in gaming for many years, but we are successfully expanding our influence to become a family of specialty retail brands, that makes the most popular technologies affordable and simple.

Our early efforts were primarily focused on expansion into digital gaming, and produced opportunities such as the acquisition of Kongregate, which continues to perform very well for us. Since our acquisition in 2010, Kongregate revenue has grown at a 75% compound annual growth rate. Kongregate has launched a number of successful mobile games, such as Tyrant, Game of Thrones and Adventure Capitalist, and PowerUp Rewards has proven instrumental in driving awareness and customer acquisition.

This is in addition to our internally-developed opportunities, such as the sale of downloadable content in our stores, and on GameStop.com. As Tony mentioned, GameStop now has an estimated 42% share for downloadable content sales.

In recent years, we have expanded our focus to include a broader array of adjacent categories, in which we believe our core competencies of real estate, consumer relationships, retail execution, buy sell trade, and disciplined capital allocation can be brought to bear. Our biggest recent success was the formation and expansion of our Technology Brands business unit, which includes our AT&T Wireless, Cricket, and Simply Mac stores.

These businesses leverage core GameStop competencies, and in return, have given us new leadership such as Jason Ellis and Steve Bain, and category expertise in wireless and in Apple retail. As we have discussed, this business unit is projected to reach $1.5 billion of sales by 2019.

We remain focused on exploring and exploiting new opportunities with significant total addressable markets that provide growth, and leverage our strengths. For example, the wireless category, roughly $185 billion in the US. We are now one of AT&T's largest and most productive dealers.

The Apple products ecosystem, which exceeds $50 billion in the US. We are now the number one Apple specialist retailer.

And most recently, the market for video game, movie, and pop-culture licensed merchandise, which is estimated to be over $20 billion worldwide. We see it as a great opportunity to offer a wider array of attractive products to our PowerUp members, both in-store and online. We expect to quickly become the market leader here as well, as we utilize our brand, store footprint, multi-channel selling capabilities, and PowerUp Rewards. We will provide updates on this initiative throughout the year.

Our efforts to date have delivered significant new diversified growth platforms for GameStop. It is worth noting that in 2014, our business outside physical video games totaled $1.6 billion, or approximately 16% of total revenue, and we expect it to grow to at least $2 billion, or more than 20% of revenue in 2015. We are very pleased with the progress to date, and are investing in these platforms to drive continued growth, but we are actively seeking additional growth platforms as well. We are exploring acquisition and partnership opportunities that leverage GameStop's core competencies and provide great value and growth for our shareholders, both in the US and in our international markets.

Finally, a few quick thoughts on PowerUp Rewards. PowerUp membership grew 13% in 2014, and is now over 30 million members in the US. International membership grew 30%, and is now 10.7 million members.

PowerUp represents 74% of total spend, and on average, members spend three times more than non-members. Average annual spend per member grew 5% to $323 per year in 2014. We continue to expand and innovate to enhance the appeal for our members.

One example is our PowerUp Rewards credit card, which was launched last fall. To date, we been able to grant over $225 million of new credit to our members, which will support new purchases such as the growth of next-generation hardware and software. I will now turn it back over to Paul.

Paul Raines - *GameStop Corporation - CEO*

Great. Thank you, Mike. I guess at this point, we will now open it up for question-and-answer, operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Brian Nagel, Oppenheimer.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Nice quarter. Couple things, couple questions. First off, on the pre-owned or used business, recognizing that currency was a factor there, in how it was reported, but it's still somewhat sluggish. As you look at 2015, and the trajectory you laid out pretty explicitly your thoughts about new software sales. How should we be thinking about the pre-owned business going through the course of this year, relative to the new software business?

Paul Raines - *GameStop Corporation - CEO*

Sure, Brian. Rob do you want to take that?

Rob Lloyd - *GameStop Corporation - CFO*

Sure. Remember that in the fourth quarter, pre-owned is typically not the hot items that the gift giver wants to give to their family. Fourth quarter is never our highest growth period for pre-owned.

But as we look forward, as I mentioned in my comments, when we compared our estimates of where the analyst models were on a category by category basis for our business, we were comparable, in most of the categories. Pre-owned was one of those. Digging into that data, you would see that we are forecasting growth for pre-owned.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Got it. The second question I wanted to ask, regarding the first-quarter guidance here, we're almost two-thirds of the way through the quarter now. And the guidance, especially with sales, it's a relatively wide range. Can you make some comment as to how we are tracking right now?

Paul Raines - *GameStop Corporation - CEO*

Want to take that one?

Rob Lloyd - *GameStop Corporation - CFO*

Well, we put out the range that we put out based on the information that we have to date, and one of the aspects of our business that we have seen historically is sort of a pre-Easter and post-Easter phenomenon. And so that remains a little bit of a wild card for us.

Paul Raines - *GameStop Corporation - CEO*

Easter this year Rob, is several weeks.

Rob Lloyd - *GameStop Corporation - CFO*

April 5. We also have foreign exchange impacts, that as many of you that are following those markets know, have been pretty substantial and impactful to international businesses.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Okay, thank you very much.

Operator

Seth Sigman, Credit Suisse.

Seth Sigman - *Credit Suisse - Analyst*

Thanks, good afternoon, and thanks for all the color. I had a question about capital allocation. When you look at the $150 million to $170 million CapEx you are guiding to, second year in a row where you have had a stepped up CapEx. How much of that is Tech Brands, what are you embedding in there?

And secondly, how does that affect your ability to buy back stock at this point? How much cash do you feel comfortable with retaining on the balance sheet? Is a more room to lever up potentially, like you did in 2014? Just trying to think through those things. Thanks.

Paul Raines - *GameStop Corporation - CEO*

Sure, if you think, Seth, back a couple years in terms of what our rate had been on CapEx, it was in the roughly $130 million range. The difference between that and what you saw in 2014, and what we'll see in 2015 is Technology Brands, and the reason that we've ranged it, which we haven't done, I think, in a while is because of the wild card associated with the RadioShack stores, and our ability to negotiate for those leases, that Tony talked about. I think as we look at the ability to buy back shares, we're pretty confident that we can continue to do share buybacks in excess of $200 million, would be the minimum for the year. And still allow ourselves to do what we want to do, in terms of acquisitions and capital, dedicated to Technology Brands.

Rob Lloyd - *GameStop Corporation - CFO*

Plus one thing to do remember is that there was a time here, years ago, where it was uncomfortable with lots of things, debt and buybacks, and everything else. But our Board today is very progressive and I think is very comfortable with our capital allocation, disciplined capital allocation, the way it has been and the way it's going to go forward. That's not a barrier, either.

Seth Sigman - *Credit Suisse - Analyst*

Okay, and then a question on Tech Brands specifically. Just wondering if you could discuss the EBIT margin performance for that business line in the fourth quarter? If you can back into it from the annual numbers you gave, it seems to imply a pretty big drop in the margins versus the third quarter. And at the same time, when you look at the mobile and CE category, it also seems to imply a big drop-off in the gross margin versus prior quarters. Any more color there? Thanks.

Paul Raines - *GameStop Corporation - CEO*

I'm sorry, could you repeat the last part of the question there?

Seth Sigman - *Credit Suisse - Analyst*

Within your mobile category, when you break out the gross margins, it seems to imply a big drop in the gross margin in Q4 relative to Q3.

Paul Raines - *GameStop Corporation - CEO*

Tony, do you want to talk about that? One of the things about the other businesses, you have various promotions and holiday things coming and going. So Tony, do you want to take that?

Tony Bartel - *GameStop Corporation - COO*

Absolutely. One of the things that takes place is that you do have shifts between sales and gross margin rates, and that's one of the things that did take place during the fourth quarter, is we had a shift. Based on the compensation programs that we have with AT&T, which is our exclusive partner, you will sometimes get shifts, so you will see those margin rates fluctuate, but you will see gross margin dollars be more consistent.

Seth Sigman - *Credit Suisse - Analyst*

Is there a way to think about the annual gross margin rate for that category going forward?

Paul Raines - *GameStop Corporation - CEO*

Rob, do you want to take that?

Rob Lloyd - *GameStop Corporation - CFO*

Yes, I would say probably -- what we saw in 2014, if you think about the mobile and consumer electronics category, as we categorize sales, the margin rates, if I remember correctly, were between 35% and 40%. and I would say think about that category in that range, and of course that contains Technology Brands.

Paul Raines - *GameStop Corporation - CEO*

As an example, Seth, you'll have promotions on a particular SKU, where you won't have the inventory in the store. You will sell the product, but you will not bring the retail of the hardware of the handset, but you will get all the gross margin. Those promotions come and go with various carriers, and so that's what makes this a little more complex than the video game business.

Seth Sigman - *Credit Suisse - Analyst*

Okay, thanks. Good luck.

Operator

Chris Merwin, Barclays.

Chris Merwin - *Barclays Capital - Analyst*

Great, thank you. I just had a couple questions. The first one is, can you talk a bit about what the DLC attach rate is at your retail stores, and how that compares to the last cycle? Are you seeing some stability in the mix shift of DLC being sold at the retail stores versus on consoles?

And secondly, in terms of the impact that the digital download business is having on physical sales for new-gen, have you found that some genres like shooters are doing better? Where maybe the resale value is a bit higher for the customer, or is it a pretty consistent across all the genres of titles that you sell, and do you see that changing over time? Thank you

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Paul Raines - *GameStop Corporation - CEO*

Sure and welcome Chris to the call. Tony, that sounds like one of your -- right up your alley.

Tony Bartel - *GameStop Corporation - COO*

Sure. On the DFC shift, it's a little hard to talk about the launch over launch, because there really was no DLC when the 360 and the PS3 launched, so it's a business that's really created. Then created since then, and quite honestly, it's been accelerated since GameStop got into that business.

So when we look at attach rates, we will typically attach about 30% to 40% of add-on downloadable content to a title when it launches, and that tends to be fairly consistent, regardless of genre. There are obviously some price point differences, so if you have downloadable content that is a higher price, you get a slightly lower attach rate, but essentially, it's a very strong attach rate. And again, that really is our associates, who are selling that at the time of launch, that drives our 42% market share.

Paul Raines - *GameStop Corporation - CEO*

Tony, do you want to make any comment on the trade-in business on genres? Any genres getting more trades?

Tony Bartel - *GameStop Corporation - COO*

On the trade in business, we see a very consistent, across genres, and very consistent really across AAA titles, I think. And some that have a little stronger downloadable content will actually trade in, the trade-ins will be a little bit delayed, but the percent of trades that we get are generally very strong. They typically come in from 45 to 90 days after a game has launched.

Amir Rozwadowski - *Barclays Capital - Analyst*

And then tailing on Chris's question, this Amir Rozwadowski, the telecom analyst at Barclays. I was wondering if I could touch upon some of the increased efforts you folks have had been placing an additional product distribution capabilities and opportunities? Specifically, it seems that phone distribution has picked up momentum, largely due to your partnership with AT&T, including the Cricket brand. I was wondering if you could provide some additional color on the pace of the business, the specific drivers for growth.

For example, are you seeing an opportunity to work with AT&T in consolidating their distribution strategy? Tapping additional markets where they may not have an active footprint? And were you to see contribution from -- or where do you expect to see contribution from this segment over the mid to longer term?

And as a second question, AT&T seems to be on the verge of closing a pretty large transaction with DirecTV. Should that deal happen, hypothetically, what type of additional opportunities could you see with a new product segment, given your partnership with the carrier? Thanks a lot.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Amir, and welcome to the call. Tony, before you get started, I would just say two things that are important from our analyst day last spring. One of which was how highly fragmented the AT&T dealer base is. It's extremely fragmented. You are talking thousands of stores in the hands of hundreds of dealers, so one of our roles here is to consolidate and improve the execution of those dealers.

The second part is the whitespace where they don't have distribution. We are trying to play a role in that. Tony, do want to talk about the rest of the stuff?

Tony Bartel - *GameStop Corporation - COO*

Sure, in terms of pacing, it's been a very aggressive pace, and it's been a great partnership with AT&T, and an exclusive relationship has really allowed us to drive the speed. Since September 2013, when we first engaged with Spring Mobile and AT&T, we've expanded the door count from 90 to 361, so it's really a hyper growth pace, and we're a very productive dealer for AT&T, and they see us that way.

Not only are we one of the largest and the fastest-growing, but we're also one of the most productive, and consistently score as one of the highest, if not the highest in customer service rankings. So that's allowed us to have an opportunity to help them consolidate the market. As we mentioned earlier, we did 16 acquisitions, and on average, when we do an acquisition, we see a 30% increase in the business, which is obviously good for us, and good for AT&T.

And I think you asked about markets where we are helping AT&T enter into, where they may not be. And we've opened 123 stores in really true whitespace areas like metro locations, and secondary markets. And then, from a long-term growth perspective, I think Rob mentioned that we're going from $33 million of operating earnings to $170 million in 2019. So it's a very relevant part of our business, and will become an increasingly larger part of our earnings.

Paul Raines - *GameStop Corporation - CEO*

The other thing, Amir, when you talk to our team, Jason Ellis runs Technology Brands, Steve Bain runs Simply Mac, Brett Bradshaw runs Spring Mobile, and Tommy Aoki runs Cricket. When you talk to them about DirecTV, they get excited about it, but we're already selling U-verse, and we're selling Digital Life, I think in half to two-thirds of our stores, so we know how that process works.

We look forward to the DirecTV sale. We look forward to the Mexico integration, as well. I think that side of the business is very healthy.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for the incremental color.

Operator

Colin Sebastian, Robert Baird.

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

First off, in terms of the guidance, the margins look like they are in line with expectations, and so looking at the difference between EPS and consensus versus guidance, I think there's roughly $0.15, Rob, you pointed out from FX, and from the higher share count, just trying to piece together the other portion. Is that mostly the lower software sales number that you have, versus consensus, or is it more of the tax and the store closures? Maybe you can clarify that? That is the first question.

Rob Lloyd - *GameStop Corporation - CFO*

Within the models, there is a lot of things that move around, but when we boiled it down to what were the biggest impacts, it was FX, it was the share count, but the single biggest difference, which is why we addressed it in the way that we did, was the projected software growth.

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

So that's the single biggest the impact of the year. Versus consensus.

Rob Lloyd - *GameStop Corporation - CFO*

Yes.

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

Okay. I guess secondly, as a follow-up on the capital allocation question, you mentioned M&A a couple of times, so I just want to clarify how that might impact, or any change to the way you think that might impact capital allocation for returning capital to shareholders?

Rob Lloyd - *GameStop Corporation - CFO*

Well, again, we're pretty confident that we can do everything we want to do from a Tech Brands expansion standpoint, a buyback standpoint, and pay the dividend at $1.44 per share during the course of the year. Should something come across our plate, that we believe drives the kind of returns that we're looking for, we would certainly discuss that at that time.

Paul Raines - *GameStop Corporation - CEO*

In the past year, we've done, what did you say, Rob, 16 transactions?

Rob Lloyd - *GameStop Corporation - CFO*

Right.

Paul Raines - *GameStop Corporation - CEO*

Those were highly accretive, and I think those are opportunistic. In nature, we frequently will get a call from one of our partners, AT&T or Apple, and they will guide us to someone who is looking to exit their business. Those are opportunities we got to take when we can. I think shareholders would want us to do that, if the returns are significantly higher than our hurdle rates. So otherwise, we are going to be buying back and paying dividends.

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

Okay. Thanks, Paul. And then lastly, another clarification on attach rates. With and without digital, obviously a lot of discussion of where attach rates will be moving to over the course of the cycle. Can you maybe qualitatively talk about, looking ahead, where you would expect the attach rates to move? That's obviously a key where we can model your sales and your margins going forward. Thanks.

Paul Raines - *GameStop Corporation - CEO*

Tony, do you want to talk about where attach rates would go? One question there, Tony, might be how many titles actually have DLC. We used to talk about which titles the DLC and which don't.

Tony Bartel - *GameStop Corporation - COO*

Just for clarification, Colin, you're talking about attach rate per console?

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

That's correct.

Tony Bartel - *GameStop Corporation - COO*

Right now, GameStop's nearly 6, whereas the industry is at 4, so we're significantly outpacing the industry, and that's really what's driven our share gains. So I think what we have seen, as I very quickly talked about earlier, we had seen a very quick acceleration of the install base, over 30 million units already are installed. So it's been an incredibly quick progression. What we are seeing is when the new innovation comes out, we're actually seeing a very strong pick up on that. So we expect to see an acceleration, and I would anticipate that we would close that gap somewhat. You talked about a gap and it's a little less than one unit per console, and when you add in digital, we're basically flat. So I would anticipate that on the physical side, we will close some of that gap versus the prior launch, as the software actually catches up with the strength of the hardware launch.

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

Okay, great. Thanks a lot.

Operator

Mike Olson, Piper Jaffray.

Mike Olson - *Piper Jaffray & Co. - Analyst*

Did you say that -- what you expect specifically next-gen software sales growth for the Company will be in 2015? And what you think your share of next-gen software sales will be in the year?

Paul Raines - *GameStop Corporation - CEO*

What we said was we believe that they will be over 50%. Obviously, ranges imply different levels, but at the bottom end we see next-gen sales of software growing over 50%. I'm sorry the second one?

Rob Lloyd - *GameStop Corporation - CFO*

The market share.

Paul Raines - *GameStop Corporation - CEO*

Our goal in everything that we do is to be dominant in the video game category. What we have seen thus far is software share hovering around one out of every two games that get sold for next-gen consoles, and our teams across the globe are focused on continuing to drive our market share.

Mike Olson - *Piper Jaffray & Co. - Analyst*

Okay and then gross margin was fairly positive in the year. What do you expect for gross margin in 2015? What are you expecting for new software, versus what you are expecting on the Tech Brands side? Should it continue to improve or will legacy gen weakness for new software potentially bring gross margin down year-over-year?

Paul Raines - *GameStop Corporation - CEO*

Well we didn't give specific guidance on where we see the gross margin rates, but directionally, we would expect that we will have a shift during the next year from hardware into software, on the video game side of things. So that is beneficial to margin, and then we will continue, as we have talked about, to aggressively grow Tech Brands. And we know that is margin accretive, so we think we see a good margin year ahead.

Mike Olson - *Piper Jaffray & Co. - Analyst*

All right. Thanks very much.

Paul Raines - *GameStop Corporation - CEO*

A record gross margin year ahead. Thanks Mike.

Operator

Arvind Bhatia, Sterne Agee.

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

A couple questions, here. First one is on the next-gen and the downloads that we are seeing there. You had a nice slide there. Just wondering what your learnings are from the PC download market, that you can apply to downloads in consoles?

Second question is wondering what your model is for hardware units, for next-gen in 2015 versus 2014? And then last question is on Tech Brands, wondering if your 2016 targets that you provided, we should still look at them as well as we look at the long-term targets? Thank you.

Paul Raines - *GameStop Corporation - CEO*

Wow, that's an interesting question. Let's see, Tony do you want to start of the next-gen downloads?

Tony Bartel - *GameStop Corporation - COO*

Sure. On the next-gen downloads, as we talked about, when you look at the actual amount of paid downloads, it's still 2%. We've always said there will be an increase in the amount of digital, and that's been clearly stated in our market model, so we anticipate that we will see that.

As to learnings from the PC digital side that you asked about, what we see right now, is we see an incredible increase taking place in the PC side, as people are coming into the business. I think it's important to remember that on the PC side of the business, historically, there has always been DRM limitations that have had a significant restriction on pre-owned, and so you really didn't have the residual value that you do on the console side of the business.

I think that is one important thing that you have to realize about the console side of the business, is that $20 residual that's in the mind of the customer is a really important piece of the business. Rob, I'll let you --

Rob Lloyd - *GameStop Corporation - CFO*

In terms of the hardware units, the comment that I made in the script was that we see growth, slight growth in next-gen hardware. I was speaking in terms of dollars, and you may think about it, that we have to overcome the price point on the Xbox One for the entirety of the year, relative to where it was in November of last year, and pretty much held there through the fourth quarter. So that would imply a slightly larger increase in units for that. And again, we don't forecast any sort of price declines on hardware until we absolutely know something, and we don't know anything right now.

So you asked about 2016 Tech Brands targets, and what I would say to you is at the beginning of last year, when we laid out our 2016 goals for Tech Brands, with respect to revenue, we were in the very early days of the next program, and as we have discussed in the past, the next program, as Paul just mentioned it a few minutes ago, changes the dynamic of how we recognize revenue. I would think in terms more of what we talked about today, on a long-term basis. That's that almost $1.5 billion in revenue by the end of 2019. And I would say to you that is formed based upon how the programs work today, and they move around.

For us, what we're more focused on is the operating profit. We'll see that growth, as we go from the $33 million that we did this year, up to the target that we laid out for you for 2019. I'd rather not specifically say how that might have changed the target we previously laid out for 2016. Candidly, I don't have that information in front of me.

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

Okay. It's very helpful. Thank you.

Operator

At this time we have time for one final question. Tony Wible, Janney Capital Markets.

Tony Wible - *Janney Montgomery Scott - Analyst*

I was wondering, how much of the digital that you're now selling happens in store versus online? And if I'm reading this correctly, the 42% share that you guys referenced, that's just DLC. So I was wondering if you had that for full game downloads, in addition to DLC?

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Paul Raines - *GameStop Corporation - CEO*

Tony?

Tony Bartel - *GameStop Corporation - COO*

95% of what we sell, Tony, is sold in the store, as opposed to online. And in terms of the market share, that's what Rob was talking about earlier, we do not have market share information on information beyond the downloadable content, add-on downloadable content, that's what Rob was talking about. We hope to share more information, as it becomes available from DFC Intelligence in the future.

Paul Raines - *GameStop Corporation - CEO*

Tony, one thing on the DLC, or digital generally, the reason it's so important to understand it's sold in stores, because that's the place that we discover, provide guidance to the customer, et cetera. It's not because we happen to have a lot of stores. Because we could put all kinds of things online, and they won't get sold, because the customers have a hard time in this category, discovering that product. That's one of the reasons why we have so much store activity.

Tony Wible - *Janney Montgomery Scott - Analyst*

Okay, and you are expecting to ramp a huge amount of tech stores this year. I was wondering if you could just give us a little bit of sense on timing for that. Are you expecting a smooth build out and conversion as you get the RadioShack stores and other stores, or should we expect some lumpiness with that? And also, I presume on the closings, we might have some lumpiness, and seeing maybe more closings in the first part of the year, versus later?

Paul Raines - *GameStop Corporation - CEO*

Tony, do you want to start with that?

Tony Bartel - *GameStop Corporation - COO*

Sure. Tony, what I would say is that with the whitespace stores, and obviously, you know about the RadioShack stores, and we have -- we are obviously working, as Rob said, feverishly right now, to get those opened, so those -- you understand that may slightly front load actually the amount of stores from a whitespace and a RadioShack perspective. I would say the conversions will happen pro rata throughout the year, and acquisitions will be probably the lumpiest part of that equation, as those come from our partners at AT&T, and as we are able to negotiate those.

Tony Wible - *Janney Montgomery Scott - Analyst*

Got it. Great. Thank you.

Paul Raines - *GameStop Corporation - CEO*

Great. Thank you, Tony and thanks to everyone. Thank you for your support of GameStop, and we'll look forward to seeing everyone on the next call. Take care.

Operator

That concludes today's presentation. Thank you for your participation.