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GME - Q2 2016 GameStop Corp Earnings Call

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OVERVIEW:

Co. reported 2Q16 operating earnings of $58.3m and EPS of $0.27. Expects 2016 revenues to range from down 2% to up 1.5% and EPS to be $3.90-4.05. Also expects 3Q16 revenues to range between plus 2% and plus 5% and EPS to be $0.53-0.58.

CORPORATE PARTICIPANTS

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Tony Bartel *GameStop Corporation - COO*

Jason Ellis *GameStop Corporation - SVP of Technology Brands*

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PRESENTATION

Operator

Good day and welcome to the GameStop Corporation's second-quarter 2016 earnings conference call. A supplemental slide presentation is available at investor.gamestop.com. At the conclusion of the announcement, a question-and-answer session will be conducted electronically.

(Operator Instructions)

I would like to remind you all 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'd like to turn the call over to Paul Raines, CEO. Please go ahead, sir.

Paul Raines - *GameStop Corporation - CEO*

Thank you, operator.

And welcome to the second-quarter earnings call for GameStop. We thank our associates for their hard work serving our customers every day. We also want to reach out to all our associates in the areas affected by the Louisiana floods, as well as the earthquake in Italy. Our thoughts are with you and we are supporting you through our internal gamer fund foundation and our HR teams.

Speaking today on our call are Rob Lloyd, Chief Financial Officer; Tony Bartel, Chief Operating Officer; and Jason Ellis, Senior Vice President of Technology Brands. Our executive staff are in the room, as well. As we pointed out in our press release, we achieved earnings at the higher end of our guidance but the process was different from what we had originally planned.

Our Technology Brands business performed well beyond expectations with revenues up 55% and operating earnings of $13.9 million. This segment contributed close to 24% of our overall earnings and we reaffirm our guidance of $85 million to $100 million of operating earnings in FY16.

All of this success in Tech Brands comes as we also acquired 507 AT&T stores from three different dealers for approximately $440 million. These deals are intense and require a massive effort across our organizations in Dallas and Salt Lake City and I am proud of the entire team in getting them across the finish line. Jason Ellis is here today to share his thoughts with you.

A key point to understand on the dealer acquisitions, usually these are individual entrepreneurs who have held these enterprises for many years and have decided to begin seeking an exit. As they start their process, it is vitally important to present GME as a viable buyer, not just from a financial point of view, but also as a responsible steward of their employees and growth trajectory.

Each entrepreneur has a relationship with AT&T and an annuity like SMF flow. So these acquisitions require management of emotions and a lot of approvals. Excluding our merger with Electronics Boutique, one of thesis the second largest acquisition in our history and it will approximately triple our operating profit in the Technology Brands division in one year. Mike Hogan on our executive staff continues to lead our broad operations and legal team through these complex deals and they are a key weapon in the search for growth.

The physical video game business declined again during the quarter with less title count and pre-announced hardware upgrades driving consumer behavior. We had anticipated softness in the physical market, but our ability to diversify our revenue and profit streams has allowed us to ride out this cycle successfully.

We are also creating our own reality by releasing our first intellectual property, Song of the Deep. Song of the Deep has been above our targets for the first six weeks and is well above 120,000 units in sales. What is interesting is that we have built a complete physical, digital and collectible ecosystem around this intriguing IP, working with another great partner at Insomniac Games to create a renewable franchise. Yes, we also take trades on this title.

Our next new title called Deformers from the studio Ready At Dawn is coming soon. Our Digital receipts grew 3.3%, a respectable number in this environment, but if you look closer, you will see the growth was driven by Console Digital and was in line with our publishing partners.

Remember, we now have all the old digital products and services, but also are launching our own IP to take advantage of the gaps in the calendar and the richer margins these games provide. Tony Bartel will share more with you on our video game business.

The Collectible business is frankly a phenomenon. Our PowerUp Rewards members have told us they enjoy these products and led us to the ThinkGeek acquisition and we continue to be pleased with the growth in this margin-rich category. Through the good works of our global merchandising, marketing and store teams, we have seen very successful launches of what seems like a new IP every week.

Among others, we have seen great success with Pokemon products of all kinds, Five Nights at Freddy's and pop vinyls from Suicide Squad. Our growth in Collectibles was over 120% and you may have noticed how quickly our team has expanded the linear footage in our stores for Collectibles. It's not gotten a lot of attention, but our ability to move with velocity to execute new sets in our stores to take advantage of Collectibles growth has been a key to our success for several quarters in this category.

As we continue to gain market share and global scale, we see future opportunities to partner, not only with video game publishers, but also with major film studios on the longer-term IP to drive future growth. We have asked Mike Hogan and Mike Mauler to partner on creating a new vision for our licensing business and we'll update you on our next call.

I will repeat what I said on this earnings call one year ago and what we told you at our investor day in April of this year: Our ability to diversify our business has been the correct strategy. Building on our leadership in video games while exploiting our core to grow rapidly in digital, mobile and collectibles.

Our PowerUp Rewards membership of 49 million members globally is our core data asset to mine for new categories of consumer demand. It is as true today as it has been for several years that GME is driving a high rate of internal change. As we wait for new consoles and virtual reality, which are coming, we are not standing still and have built several new businesses.

We believe the new GME has compelling value for our investors. You should note that our 37.9% gross margin rate for the second quarter was the highest in our history. And while there is mix shift, we have also diversified into richer margin lines of business. We provided guidance for Q3 that is modestly up and reaffirmed our full-year guidance.

We continue to spend a lot of time internally and with our Board on our strategic plan, assessing the size of markets and their adjacency to our customer base. A high rate of change will continue to define us and will protect our family.

I will now turn the call over to Rob Lloyd.

Rob Lloyd - *GameStop Corporation - CFO*

Thanks, Paul. Good afternoon, everyone.

In a testament to our I diversification strategy and fiscal metrics, we deliver earnings on the higher side of our guidance range despite the challenges we faced in the core video game business in second quarter. Our earnings of $0.27 per share resulted from significant contributions by Tech Brands and Collectibles.

Tech Brands' revenues grew 54.6% to $175.9 million and Tech Brands' operating earnings were $13.9 million, compared to $400,000 last year. Collectibles sales grew 120% to $90 million. On the strength of our new higher-margin businesses, consolidated gross margins were 37.9%, an all-time high, up 500 basis points from last year.

As you know, NPD results were down 31% in hardware and 12.5% in software for the quarter. We saw declines in hardware of 33.4% and in software of 18.2%. The largest titles in the quarter were released in May with very difficult overlaps in June and even July. We gained share in May with titles like Unchartered 4 and Overwatch. We lost share in June and July, which happens when there are no notable titles.

We saw a noticeable drop-off in hardware sales after announcements or rumors of console refreshes leading into and during E3. Paul mentioned that we completed three AT&T acquisitions. We had one transaction closed at the end of May and the other two on the first day of the third quarter.

Now for more depth on our results. Total sales decreased 7.4% in the quarter, greater than we expected, due to the hardware declines. The FX impact on sales was marginal at negative $5.1 million for the quarter, and we don't expect much impact for the full year. Comparable store sales decreased 10.6% for the quarter, driven by the decline in hardware and software.

The US comp was down 12.5%. And international comps were down 5.9%. The negative hardware and software impact caused a comp decline of just over 12%. The positive impact of Collectibles on the comp was approximately 2.5%. Omni-channel sales increased 16% during the quarter. Operating earnings were $58.3 million, a decrease of 4.1% compared to the results for Q2 2015, excluding ThinkGeek and Radio Shack deal costs.

29% of our operating earnings in the last 12 months came from sources other than physical gaming. In 2015, we had 25% of our earnings come from non-physical gaming. Again, we expect 30% or more of our FY16 operating earnings to come from sources other than physical gaming.

SG&A as a percentage of sales increased from 27.8% in the prior-year quarter to 31.8% for this year's second quarter. The increase was due to the decline in sales overall and the growth of Tech Brands. SG&A in the video game brand segments declined $8.1 million, but increased as a percentage of sales from 26.6% in the second quarter of last year to 29.6% this quarter, due to the comp sales decline.

Coupled with reductions in the first quarter, we've reduced SG&A in the core GameStop branded stores by $15 million year-to-date, on our way to our $30 million reduction goal for the year.

Interest expense increased by $8 million year-over-year due to the issuance of senior notes in March. Net income increased $2.6 million, or 10% from $25.3 million in the second quarter of last year, which included acquisition-related charges of $9.1 million.

Now let's look at performance for some of the categories. We covered hardware and software sales already. Hardware and software margins increased from the prior-year quarter due to lower freight costs and higher cooperative advertising dollars as a percentage of sales. Pre-owned sales declined 3.2% during the quarter but significantly outperformed the declines in hardware and software.

Pre-owned margin for the quarter was 45%. For the full year, margins are expected to come in between 44% and 47%. Digital receipts increased 3.3% driven by DLC and console currency cards. GAAP digital revenues decreased 12.7%, trailing the decline in software during the quarter. GAAP digital gross profit was comparable to Q2 of last year with the margin rate reaching 90.1%.

Collectibles grew 119.5% with a margin rate of 38.6%. The decline in margin rate year-over-year is due to the addition of thinkgeek.com. As we discussed on our call in May, third party fulfillment costs for ThinkGeek impacted category margin rate for the quarter. We will complete the move of the ThinkGeek distribution operations into our Louisville distribution center in early 2017.

Other key information includes we closed a net of nine video game stores and now have 3,945 in the US and 2,009 internationally. We acquired 507 AT&T branded stores and opened a net of five Technology Brands stores and now have 1,566.

Now that we've completed the acquisitions of additional AT&T stores, I wanted to recap our capital allocation strategy and our disciplined approach to returning our excess cash to shareholders. Our capital allocation strategy, which is regularly reviewed with our Board, remains the same. Disciplined investments in the business, including value accretive acquisitions are a priority.

And to the extent those investments do not require our free cash flow, we return free cash flow to shareholders in the form of dividends and share repurchases. Some history may be helpful.

In 2010, because we were generating a significant amount of free cash know, our Board concluded it was the right time to re-evaluate our capital allocation and begin to return free cash flow to shareholders in the form of share repurchases.

In 2012, the Board initiated a regular quarterly dividend and our Board has approved annual increases in the dividend, raising it from $0.60 per share at inception to $1.48 now. We target all M&A and new store investments to meet an IRR of 20% and the IRR for Technology Brands investments we've made since 2012 has been well above the Company's cost of capital and the IRR targets.

Looking ahead, as we plan for FY17, the Board will analyze our long-term strategic model to estimate the amount of free cash flow available for M&A and share buyback after considering dividends and sufficient liquidity. While we did not buy back any shares in the quarter due to our M&A activity, we expect to buy back between 75 million and 125 million this year. As in the past three years, we will continue to use 10b5-1 plans to execute our buyback for consistent, non-market timing purchases.

Now I'll move on to third-quarter guidance. Revenues are forecast to range between plus 2% and plus 5%, with same-store sales ranging from down 2% to plus 1%. Hardware sales are expected to decline approximately 20%, which could negatively impact the same-store sales by approximately 4%. We expect software sales to range from down 5% to flat.

This improvement from the second quarter, plus the expectation of flat pre-owned sales and the growth in Collectibles forms the basis for our Q3 same-store sales guidance. As we look at the months in the quarter, we expect new software for the industry to be flat to slightly down in August. We expect September to decline as we have NBA 2K17 and FIFA but nothing to compare to Metal Gear Solid IV through VI, Mad Max and Super Mario Maker from last September. We expect October to grow on the potential of Mafia III, Battlefield 1 and Titanfall 2.

Collectible sales are expected to grow more than 40% from the $80 million in sales in last year's third quarter. Tech Brands sales are expected to grow more than 65% in the third quarter. We expect operating earnings from Tech Brands to exceed $20 million for the quarter, driven by the 507 stores we just acquired.

For the back half of the year, we expect to achieve over $50 million in operating earnings for Tech Brands, reaffirming our investor day guidance of operating earnings of $85 million or more. As we've said previously, we expect the projected earnings from the acquired stores to more than offset the interest expense from the date of the debt issuance.

The projected increase in operating earnings coming from Tech Brands and the margin from Collectibles are expected to more than offset the decline in hardware sales. Therefore, total operating earnings are forecasted to grow 10% or more for the third quarter. We expect interest expense to increase by about $9 million from last year due to the additional debt and seasonal borrowings on our line of credit during the quarter.

We expect earnings per share for the third quarter to be in a range between $0.53 and $0.58 per share. Based on first-half results, we're revising certain annual sales guidance metrics as follows: We expect full-year revenues to range from down 2% to up 1.5%. We expect full-year same-store sales to range from down 4.5% to down 1.5%.

We expect hardware sales to be down approximately 20% for the year. We expect pre-owned sales to range between down 2% and flat. We still expect software sales to range from down 10% to down 5%. We still expect Collectibles sales to range from $450 million to $500 million.

We still expect Tech Brands revenues to range from $800 million to $850 million. For the full year, we're maintaining our current EPS range of $3.90 to $4.05 per share and expect operating earnings to increase between 5% and 8% from last year.

I'll now turn it over to Tony for his comments.

Tony Bartel - *GameStop Corporation - COO*

Thanks, Rob.

As we expected and consistent with Q1, the second quarter again showed the power of our transformation efforts as strong performance in our Tech Brands, Collectibles and Digital businesses offset the anticipated decline in the video game category. Jason will address impressive Tech Brands results. So I will cover our collectibles, digital, and physical video game results.

Our collectibles sales continued their strong growth, increasing 120% for the quarter. We completed the expansion of collectibles in all US stores, increasing our collectible dedicated space by more than 100% compared to last year. In select stores, we are testing a store within a store concept where over one-third of the floor space is dedicated to collectibles. We will have this in about 300 stores before the holiday season.

We also opened 10 dedicated collectibles stores worldwide during the quarter and now have 47, including four ThinkGeek stores in the US. As you know, we target a 20% IRR on all of our development and we are exceeding those targets by over 50% in the stores that we have opened so far. We've opened seven more dedicated stores since the end of the quarter and are on track to have over 80 dedicated stores by the end of the year.

For those of you in New York, I urge you to stop by our 33rd and Broadway store, which has recently been converted to a hybrid format. While the Collectibles business may experience sales spikes due to large IP launches, there are significant events or product launches nearly every week of the year, making the category much more consistent and predictable than the video game business. A sample of some of the bigger properties is provided on slide 18.

As an example of how quickly we can react to the marketplace, we capitalized on the global popularity of Pokemon GO by quickly identifying on social media our Poke Stops and Poke Gyms. In addition, we also lured both Pokemon and players to our stores through coordinated and well-disseminated efforts.

As a result, the 462 stores where we had Pokemon-related events ended up more than doubling their sales of Pokemon related items during the promotional period. To reiterate, for the full year, we expect this business to generate between $450 million up to $500 million of sales with margins of 35% to 40%.

Our console digital receipts increased despite the decline in new software sales. We continued to see growth in DLC and digital currency sales and, as we discussed on our first quarter call, we are now participating in the Digital Indy game space through our Game Trust division. On July 12, Game Trust launched Song of the Deep, developed by Insomniac Games, available on PS4, Xbox One and PC platforms.

The game has achieved strong success out of the gate, delivering sales over forecasted expectation in its first six weeks. Digital penetration has reached 20% of unit sales. Game Trust also collaborated with Insomniac Games on a full lineup of collectible merchandise from a limited edition statue and watches, a collectible pop vinyl and even a story book written by Insomniac's chief creating officer, Brian Hastings.

Our collectibles attach rate of 14% exceeded our expectations and shows the potential of creating high quality collectible merchandise in conjunction with a AAA title launch. Playing the role of publisher, exclusive physical retailer and digital profit partner, GameStop is also proving a business model where it can invest smartly in new IPs and enjoy higher margins on the sale of these titles. Our pro forma gross margin for Song of the Deep is 63%.

Game Trust has a strong lineup of games in development with innovative developers such as Ready At Dawn, Frozenbyte, and Tequila Works. These and future unannounced partnerships will continue to establish Game Trust as a leading disrupter in the $1 billion plus independent game market. Our ability to quickly transform our GameStop branded stores is a tribute to our focus on service and customer relationships.

As we've stated in the past, we deploy more than 10 times the amount of associates per square foot than our big box competitors, allowing us to execute with precision and with velocity. And through PowerUp Rewards, we are able to drive customer loyalty as 75% of our GameStop branded sales come from PowerUp Reward customers.

Lastly, physical hardware sales were down 33% and software sales were down 18% during the quarter due to weaker innovation in the video game category. To put this into perspective, the top five games launched in Q2 of 2015 generated $253 million, while the top five games launched in Q2 of 2016 only sold $194 million, a 23% decrease.

As Rob mentioned, we expect this to turn positive in the back half of the year based on console and VR launches and the strong slate of games detailed on page 11 in the online material. We are already excited about the demand that we have seen for the recently launched Xbox One S, No Man's Sky and Madden 2017.

While we still maintain a greater than 50% market share on these top five game launches, these launches represented a much lower percent of total game sales, resulting in our growth coming in under the market growth. We anticipate stronger innovation in the back half of the year and a continuation of our market share increase for the next two quarters and for the year in total.

Our pre-owned sales were slightly negative, outperforming new software declines by nearly 15 points. We were able to bring in more products in trade, providing us with upside relative to the traffic in the stores. As you can see on page 9, pre-owned continues to outpace new software growth by over 30 points in both the current and prior gen segments.

Pre-owned stock is in a good position with average per-store Xbox One and PS4 inventory levels up 29% over last year. This was helped by the recent sold-out launch of the 2-terabyte Xbox One S, where 37% of consoles were funded with trade credits. We anticipate similar strong trades towards VR products, the 1-terabyte Xbox One S, and the strong lineup of games in the back half of the year.

Our transformation is in full swing. In the near-term, we expect to dominate the video game market as innovation picks up in the back half of the year, driving trades and resulting in pre-owned sales. Longer-term, as Tech Brands, Collectibles and Digital receipts continue to grow, we expect to increase our GameStop branded average store contribution by at least 8% over the next three years.

I will now turn the call over to Jason.

Jason Ellis - *GameStop Corporation - SVP of Technology Brands*

Thank you, Tony, and good afternoon.

My name is Jason Ellis and I'm responsible for the Technology Brands division of GME. Technology Brands has been a deliberate focus on behalf of our leadership team, to diversify GameStop's revenues and profits while at the same time building large businesses that can demonstrate category leadership and provide durable earnings.

Since its inception in October of 2013, Technology Brands has successfully leveraged GameStop's core competencies in real estate expertise, multi-unit management, buy/sell/trade and capital deployment to create one of the largest consumer technology specialty retail chains in America. The largest business in our division is Spring Mobile, which has recently become AT&T's largest authorized retailer.

Spring Mobile has been one of AT&T's most productive authorized retailers for over 10 years and since being acquired by GameStop has experienced unprecedented growth, building or acquiring more than 1,400 locations and deploying over $750 million in capital, including the recent purchase of more than 500 AT&T authorized retail locations, one of the largest acquisitions GME has ever made.

In regard to our most recent acquisitions, these have been a tremendous undertaking on behalf of the entire organization. Last year on the first day of the third quarter, our AT&T division operated 590 retail stores. And this year on the first day of the third quarter, our AT&T division operated 1,424 stores. The addition of 834 retail stores in less than one year evidences GME's ability to move with a high rate of change and continue to enforce our diversification strategy.

Last year, the Technology Brands division delivered just over $27 million in operating income. We expect to more than triple that number this year. Most operators would tell you that the heavy lifting starts after the deal closes and larger transactions are more difficult to integrate. I'm happy to report that all of the retail properties were integrated to our point of sale and inventory systems in less than 24 hours.

Almost 2,000 employees were on-boarded and received initial training during the same time period. The speed of execution allowed us to be open for business and selling to customers in all locations on day one of the integration.

While we are proud of the total growth, we are even more excited that our proprietary systems for managing the retail sales environment have proven their ability to scale. We have now improved total store productivity by more than 30% across 30 separate deals, resulting in outperforming the IRR expectations by nearly 20%. Our culture is driving better performance as we quickly scale the business and I know many you understand how difficult the combination of fast growth and improving performance can be.

The performance has continued to strengthen our relationship with AT&T and we are well aligned with their strategy of becoming the world's premier integrated communications company. The additions of AT&T products like DirecTV and Digital Life have added new revenue opportunities to our retail stores and they are valuable products to our customers. We continue to see growing consumer interest and increasing sales in each of these categories.

In addition to our progress with AT&T, we are pleased that we have strengthened our relationships with our partners at Cricket and Apple. While these relationships are relatively new to GameStop, I personally have had the opportunity to work with each of them for over 10 years.

We will continue our efforts to align with them and deliver great experiences to customers in our Simply Mac and Cricket branded retail stores. As you can tell, we have had a productive and exciting year in the division and I'm excited to share the following highlights for the quarter:

The Technology Brands division delivered operating income of $13.9 million, which is 7.8% of revenue. That is an increase from just $400,000 of operating income in the prior-year quarter. Year-to-date, we have delivered operating income of $32.7 million, which is 21% more than the entire year last year. We are on track to achieve our previous guidance of $85 million to $100 million in operating profit this year at a 10% or higher operating margin compared to just $27 million in 2015.

For the quarter, Technology Brands had gross profit comps of negative 1.1% and a decrease of 4.1% in comparable store traffic. Year-to-date, we have gross profit comps of positive 2.8% even though we have seen a decrease of 2.3% in comparable store traffic. We anticipate traffic and gross profit comps to increase over the back half of the year, driven by anticipated product launches and seasonal product sales.

As we stated at our investor day, for the full year, we expect traffic to increase 5% and gross profit comps to grow at least 3%. Due to the high level of customer experience in our sales environment, we continue to be pleased by the resilience of the category to online shopping, which has obviously impacted other retailers.

Spring Mobile has become America's largest wireless dealer and the combination of exclusively partnering with AT&T as an industry leader with the GME's core competencies and capital and a retail sales environment that has not been impacted by the Amazon Effect is undoubtedly a valuable asset to GME.

I would like to close by saying a genuine thanks to the thousands of employees in our division that have worked hard to facilitate this growth and the legacy GameStop stores for showing us the way to category leadership. We look forward to sharing our Q3 results in a short few months.

Thank you. And I will now turn it back over to Paul.

Paul Raines - *GameStop Corporation - CEO*

Thanks, Jason. With that, we will open up the call for Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

At this time, we'll take a question from Ben Schachter with Macquarie.

Ben Schachter - *Macquarie Research Equities - Analyst*

Hello, guys. When you think about store traffic for the back half of the year, how important will VR be, not necessarily in terms of dollars spent, but just bringing people into the stores?

And then relatedly, can you just remind us which hardware launches are now included in the guidance, because I don't believe PlayStation has officially launched a new PlayStation? Just remind us what's going on there.

And then for Jason, when we think about the Technology Brands business, are key launches like a new iPhone -- how important are those to what drives traffic growth and sales growth there? Thanks.

Paul Raines - *GameStop Corporation - CEO*

Okay. All right, Ben. So let's start with number one -- store traffic on VR. I think that's interesting. Tony may or may not have something to share with you.

Tony Bartel - *GameStop Corporation - COO*

Sure, absolutely. We literally have hundreds of stores that have stations in them -- VR stations in them today. In a quarter of our stores, we already have had events that have been strong traffic drivers.

We're partnering very closely with Sony. Each of our associates are going to be certified in the PlayStation VR.

As you know, at this point, we are suffering from -- in Sony's case, they're not suffering, they just haven't launched. But in the other two cases, there's a low production that is not meeting demand. But we see tremendous traffic when we run these events in our stores.

And another element of just how much demand there is -- we had the quickest sell-out of preorders in our history; the last time we were able to put a PS VR for preorder, we were out literally in five minutes. So there is tremendous demand, and, in the back half of the year, as people come in, as they talk with our associates who are incredibly knowledgeable and certified in this, we think that it will be a good traffic driver, far beyond the sales that it will generate.

Paul Raines - *GameStop Corporation - CEO*

I think we would all -- those of us who have been in the Sony meetings, I think you would see that Sony is taking this very seriously as a very meaningful driver. So there's other stuff they're going to announce that you'll hear more of.

Question number two, Rob, what hardware is included in the guidance?

Rob Lloyd - *GameStop Corporation - CFO*

The Xbox One S is in the guidance. We started selling it two, three weeks ago. We sold through what we got. We'll start selling the 2-terabyte shortly.

Paul Raines - *GameStop Corporation - CEO*

1 terabyte.

Rob Lloyd - *GameStop Corporation - CFO*

Just 1 terabyte? Oh, I'm sorry.

And then the PlayStation, the Neo is in the numbers, but in very light form, as not much is known yet. We'll know more obviously after September 7.

Paul Raines - *GameStop Corporation - CEO*

Okay. And then, Jason, you were going to talk about I think iPhones, right?

Jason Ellis - *GameStop Corporation - SVP of Technology Brands*

That's right. And thanks for the question, Ben. For this quarter in particular, iPhone is important to the quarter, and obviously any Apple product launch will drive traffic to the stores. But thanks to the diversification in the retail stores, we're also excited about the other products like DirecTV with NFL Sunday Ticket. So, there's more than just iPhone in this quarter that will drive traffic.

Paul Raines - *GameStop Corporation - CEO*

DirecTV has not had enough, I think, press on how impactful it could be for AT&T and for us.

Okay. Next question, operator.

Operator

Move now to Colin Sebastian with Robert Baird.

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

Thanks, guys -- have a couple of questions. First, just one quick follow-up to Ben's question on guidance. Is PlayStation VR included now in the second half?

Paul Raines - *GameStop Corporation - CEO*

Not huge numbers, right, Rob?

Rob Lloyd - *GameStop Corporation - CFO*

Yes, it's in the number as well, but the quantities will be very limited, we believe, this fall.

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

Okay. And then, with respect to the used margins, just given the 45% number in the quarter and your guidance, is that the level we should expect for Q3 and Q4, even as youth sales improve seasonally?

Paul Raines - *GameStop Corporation - CEO*

I think my comment was 44% to 47%, and what we're seeing there is the ongoing mix shift that drives more of the sales to the next gen products. And as we've said in the past, the next gen products don't carry the same margin rate as the older generations do. The margins just improve as the generation ages.

As well, we've been augmenting our supply with some third-party purchases, particularly on the hardware side. And those don't carry the same margin rates as we're used to.

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

Okay. And then lastly, maybe for Jason, with respect to the latest purchase of AT&T stores, the 507, I was hoping you could add some context around the attributes of the one reseller that will contribute such a large portion of profit, and if that provides some potential for upside to the operating income target? And then also what you see on the horizon in terms of additional roll-up opportunities. Thanks.

Jason Ellis - *GameStop Corporation - SVP of Technology Brands*

So, I don't think it was just one operator, but it would be the combination of the three that will give us the upside potential between now and the run-out for the rest of the year. I do believe that there's upside potential on all of them, and, as Paul said in his comments, many of the recent purchases are legacy businesses that have been doing the wireless dealer business for a long time, which means they have larger SMF streams. Their businesses are traditionally more profitable than some of the newer businesses. And we've specifically targeted those type of dealers in our acquisition strategy.

So, generally, they're higher volume with more legacy customer base, more loyal customers, and we do see that, when we put our systems in here, we will see an uptick in productivity. So overall, those stores will become more profitable. It also will help us leverage our fixed cost structure, so we'll gain some efficiency there as well.

Paul Raines - *GameStop Corporation - CEO*

What about the possibility for more dealers?

Jason Ellis - *GameStop Corporation - SVP of Technology Brands*

I'll take a big breath because we just digested all of these 500 stores. But obviously, we're hungry for more, and we think that there's runway there. And this space is very competitive, and it's been around for 20 or more years, and we think that we're a good home for a lot of people that may want to exit. So that door's open.

Paul Raines - *GameStop Corporation - CEO*

The other dynamic, Colin, is there's a lot of -- as you know, a lot of movement in the telco space. To the degree that AT&T wants to exit certain corporate stores, they will pursue us on that, too. I think the most important thing is just what an outstanding job our Spring Mobile and Tech Brands teams have done in execution so far.

Rob Lloyd - *GameStop Corporation - CFO*

Colin, this is Rob. I'll say that we gave a range of $85 million to $100 million of operating earnings. So obviously we've reflected that there's some upside inside that range as we add these stores into the mix.

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

Okay. Thanks, guys.

Operator

At this time, we'll take the next question. This will be from Curtis Nagle with Bank of America Merrill Lynch.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Great. Thanks very much for taking the question.

For the first one, I'm just curious what you guys think the impacts could be, in terms of building the console base from lower pricing on, I guess I'll call them the non-upgraded consoles, including what you guys have in your own pre-owned inventory? And then just a quick follow-up after that.

Paul Raines - *GameStop Corporation - CEO*

Okay. Tony, you want to take that?

Tony Bartel - *GameStop Corporation - COO*

Yes. I think any time that there's innovation in the pipeline, it's good for us. It really begins to operate our whole buy/sell/trade business. Like we saw, and even as I'd referenced in my notes, when the 2-terabyte Xbox One S came, and Rob said we had very limited quantities, but when we sold out, 37% of those had a trade credit attached to them. And so we do see that when innovation hits from a hardware perspective, we're able to really capitalize that from a pre-owned perspective.

So we welcome any form of innovation. And we think that the Xbox One S and whatever it is that Sony is going to talk about, as well as the Nintendo and the PS VR, are all going to be opportunities for us to provide great value for our customers, new innovation, and drive excitement in the video game industry.

Paul Raines - *GameStop Corporation - CEO*

You may want to talk about -- one of the things that someone should be modeling is console VR. If there's a percentage of trade credits applied to that similar to hardware, right?

Tony Bartel - *GameStop Corporation - COO*

Absolutely. As is usual, when you have a launch like that, that is complex, which this is, and it's expensive, which this is, what happens is we tend to get an over-allocated portion of that because we can offer trade credits. We offer the first-to-know list. We offer the preorder benefits, and we offer the PowerUp reward credits that no one else can really match.

Paul Raines - *GameStop Corporation - CEO*

Remember, Curtis, right now, so Sony has been in and out of our office many times in the past few weeks. Right now, for example, they're looking at our list of PowerUp members who own PlayStation 4, and they're thinking about how they're going to promote to those people, and figure out how to bring their trade credits in. We think we're a very powerful launch partner for them and others, but they will be most important because they have a lot of install base.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Great. Thanks very much.

And then just a quick housekeeping -- just what drove lower AP year over year? Was that just higher used inventory relative to new, or was it something else? And that's accounts payable.

Rob Lloyd - *GameStop Corporation - CFO*

Well, related (multiple speakers). I knew what you meant.

Related to AP is the increase in inventory, and Matt's already had a question come in from one of the analysts on that, so let me address that. Inventory has increased as a result of the growth of Technology Brands because of ThinkGeek and the growth of the Collectibles business, and this collectibles-dedicated store base.

With respect to that, we don't have the same leverage opportunities on the AT&T side or, in many cases, on the collectibles side, especially with products that we're getting manufactured overseas, as we do in the core video game business. We also saw a slowdown in the core video game business; and as a result, we had a lot of inventory that sustained us through the quarter, and that inventory needed to be paid for at some point in time. So you've got a different leverage ratio this quarter.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

And just, sorry, one quick follow-up on that -- are you maintaining the free cash flow guidance?

Rob Lloyd - *GameStop Corporation - CFO*

Yes.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Okay. Great. Thanks very much, appreciate it.

Paul Raines - *GameStop Corporation - CEO*

Thanks, Curtis.

Operator

At this time, we'll move forward to Mike Olson with Piper Jaffray.

Paul Raines - *GameStop Corporation - CEO*

Hello, Mike.

Mike Olson - *Piper Jaffray - Analyst*

Hello, good afternoon, guys. Couple questions -- could you expand on the reasoning you gave for why your sales were down 18% for new software when NPD was down 12%, and how that should be perceived related to market share in that segment?

Rob Lloyd - *GameStop Corporation - CFO*

Sure. This is Rob. When there are title launches, and we dominate the market share at launch, and remember that when we launch games, we typically have 60% to 70% share during the first week of launch, those shares have continued. The opportunity to get that share was dramatically reduced in the second quarter because the title count was dramatically reduced.

So what you have then is what we call the catalog portion of the software business plays a much more dramatic part of what the software sales are in the particular quarter, and we have the 60% to 70% share at launch. Our overall share comes in around 40% or so on software. So obviously, when a title moves out of that launch phase into what we call the catalog phase, we lose some share. So the lack of titles launching in the quarter is what you saw in the share decline.

Paul Raines - *GameStop Corporation - CEO*

The trade currency is much more powerful on a new title launch than it is on a catalog launch. That's our advantage.

Mike Olson - *Piper Jaffray - Analyst*

Okay. Got it. And then second one is on AT&T stores. I think one of the questions that comes up fairly often is why all these AT&T resellers are getting out of this business and selling to you if it's a business that's got kind of good go-forward prospects. Could you just talk about that dynamic and why they may be exiting those businesses as you're wanting to enter that space? Thank you.

Paul Raines - *GameStop Corporation - CEO*

That is a great question, Mike. Jason?

Jason Ellis - *GameStop Corporation - SVP of Technology Brands*

Yes. So the good news is that I was one of them originally. So most of my peers have been in this space for, like I said, a long time, 15 or 20 years. And the space is just getting more difficult in terms of the infrastructure required to run it and the expertise that's required to do it effectively.

So we're representing one of the most valuable brands in the world with AT&T. They've made tremendous investments in their network, and other products and services, and they expect that our associates will be trained. They expect the retail environment to look a certain way.

There are customer privacy requirements that need to be maintained, and just, quite honestly, the business is more complicated to run than it was 20 years ago. And some folks just are at the stage where they're not willing or capable of doing that. So, as we've discussed, we're a really good exit for those that are looking for liquidity.

Paul Raines - *GameStop Corporation - CEO*

And one of the things about these entrepreneurs running these businesses is, in many cases, they don't have a succession plan, right, Jason? So they're trying to get out. And you can't just sell to anybody, right, guys? It's an interesting segment for us, and it's got a lot of growth.

Mike Olson - *Piper Jaffray - Analyst*

Thank you.

Jason Ellis - *GameStop Corporation - SVP of Technology Brands*

Thanks, Mike.

Paul Raines - *GameStop Corporation - CEO*

Thanks, Mike.

Operator

At this time, we'll move to Brian Nagel with Oppenheimer.

Paul Raines - *GameStop Corporation - CEO*

Hello, Brian.

Brian Nagel - *Oppenheimer - Analyst*

Hello, good afternoon.

Paul Raines - *GameStop Corporation - CEO*

Good afternoon.

Brian Nagel - *Oppenheimer - Analyst*

My first question, and I guess this is for Rob, with regard to the gross margins and your new software business. You discuss this a bit in your prepared comments, but they did shift higher here in the second quarter. Maybe if you could explain in more detail the reasons behind that, and then how should we think about the sustainability of that trend as we prepare for the back half of this year?

Rob Lloyd - *GameStop Corporation - CFO*

Sure. So we talked about the inventory, and that we had inventory in the stores that sustained us more through the quarter. So obviously, moving less into stores resulted in a lower freight cost than we had last year. So lower freight cost can positively affect your margins.

Then on the -- we talked about the cooperative advertising dollars. So that's pretty well tied to, based on the accounting rules, when products launch and what the advertising that we get from our publishing partners pertains to. And so there are a lot of dynamics in how you calculate how much gets capitalized of what comes in, in a quarter.

This is down in the weeds, I get that. But it has an impact, particularly in a volatile sales environment, on what it can do within the gross profit or gross margin rate arena.

Brian Nagel - *Oppenheimer - Analyst*

Is it fair to say, Rob, that if Q3 is a more normal sales environment for new software, that there should be less of a benefit to gross margins?

Rob Lloyd - *GameStop Corporation - CFO*

It's fair to say that you would expect gross margins on both hardware and software to go back to the levels they've been at for, call it, the previous five or six quarters than what you saw in this Q2.

Brian Nagel - *Oppenheimer - Analyst*

Got it. My second question -- bigger picture in nature -- with respect to the Collectibles business, again, congratulations on the good numbers you put up there.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Brian.

Brian Nagel - *Oppenheimer - Analyst*

As I talked to our clients, one of the biggest questions I continue to get, and frankly, I don't have a great answer for, is where is that, as GameStop continues to grow rapidly in this business, where is the share coming from? And to what extent is GameStop taking share from other players or potentially even expanding the market, given the advantages you now have in the space?

Paul Raines - *GameStop Corporation - CEO*

That's a great question, Brian. Same question I had when we first started talking about this.

You'll be fascinated by what you're going to hear. There's two things here to understand about it. And I'm going to let Mike Hogan and Mike Mauler maybe talk about the two different pieces of this. But there's the fragmented nature of the market, but there's the also potential for licensing. This is a very early market.

Mike, you want to talk about it?

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

Yes, sure. I think, as we've talked before, the licensing in general is over a $100 billion business just in North America, but the piece that we're focused on, which is really sort of movies, TV, video game, pop culture licenses, is around $11 billion. First answer to your question is that is a growing segment. But in terms of growth of share, if you look at the category today, it's highly fragmented. There's no single player that has more than probably 10% or so share in this category.

And it's split up a bunch of various kinds of players from mass merch, to specialty retail, to online, a lot of one-man shops and so on. As we go into this category, what we see is there's a real opportunity for GameStop to become kind of the global leader in this.

And what we see -- a good example would be -- ThinkGeek has been a popular brand for years, and people have been coming to the website for years. And as we opened our first ThinkGeek stores, we had people coming from several states away to see what was available in that store. And it's proven to be a great sort of master brand for us to assimilate that. So we really think that there's category leadership in our future here, and opportunity to not only take share but grow the category.

We also think that there's the opportunity to go and do bigger things from a licensing perspective. And, Mike, you want to talk -- you might want to talk about that.

Mike Mauler - *GameStop Corporation - EVP and President of International*

Sure, a little bit. I think, outside of the US, there really aren't any specialty chains that specialize in collectibles and licensed merchandise. And so, worldwide, we just added 6,000 stores to this market, making the product much more accessible to the average consumer who might not, in the past, have actually looked for this type of product. That's one thing.

And we saw that also with video games over the last decade, where specialty retail made a big difference in growing the market in many different countries. And so what we've seen as we've expanded this product line -- what we're seeing people really shift their behaviors. And so, Game of Thrones will come out, and people will come into our stores and buy 50 to 100 products for Game of Thrones parties to launch the premier. And so, the culture and people's behavior is actually starting to change because we've made the product so accessible.

To Mike's point, we've added a lot of excitement about the product, both through direct licensing, design, and manufacturing. Now there's products you can't get anywhere else. We recently we've licensed, worldwide, several Pokemon products, including a Pokemon bean bag chair where we had thousands of reservations for it. It's amazing when you offer really interesting product, how people before, who never really looked at licensed merchandise, find a way to buy it and experience it. So it's really exciting.

Paul Raines - *GameStop Corporation - CEO*

Brian, go to thinkgeek.com and look at the Snorlax bean bag chair. And we're reserving that. We just had a discussion on it earlier.

What's frustrating to me is that we can't sell more of it, but it's a fabulous example of what's happening in this category. Here's the global license for a Pokemon chair that we own. Now we've got to figure out how to be smarter about reserving it, so we can do a lot more volume, but it's fascinating what's happening in this category.

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

Just one last thing -- I would be remiss if I didn't mention PowerUp Rewards, and some data that I think we had shared previously. We know that almost 50% of our current members are already buying collectibles, and we have, for example, the opportunity to go into PowerUp Rewards and identify everyone who is a Pokemon game fan, and market products like the Snorlax to them, or look at people who've, the 30% or so that are Fallout fans and direct market Fallout-related collectibles to them. So we think that's a big competitive advantage as well.

Brian Nagel - *Oppenheimer - Analyst*

Appreciate the color.

Paul Raines - *GameStop Corporation - CEO*

Look at that bean bag chair, Brian. It's pretty comfortable.

Brian Nagel - *Oppenheimer - Analyst*

I'll do it right now. Thank you.

Operator

We have time for one more question. This will be from David Magee with SunTrust.

Paul Raines - *GameStop Corporation - CEO*

Hello, Dave.

David Magee - *SunTrust Robinson Humphrey - Analyst*

Hello, guys. Good afternoon.

Paul Raines - *GameStop Corporation - CEO*

Good afternoon.

David Magee - *SunTrust Robinson Humphrey - Analyst*

I have a question regarding the favorite topic of NPD trends, and you mentioned that you expected August to be, I think, sort of flattish for software. And I guess we can use that as maybe a proxy for what your Business might be doing, which would imply a pretty nice trend change from what we saw in the second quarter.

My question is -- how distortive is it that now NPD includes digital products? Should we discount that more than maybe in the past? How should we sort of view that relationship?

Paul Raines - *GameStop Corporation - CEO*

Matt, you want to take that one?

Matt Hodges - *GameStop Corporation - VP of Public & Investor Relations*

Sure. I don't think it has that much of a material impact. I think the publishers just wanted it to show the broader market. That's all they were trying to accomplish with that.

Paul Raines - *GameStop Corporation - CEO*

We've got questions around some of the accuracy of what they're measuring, right?

Matt Hodges - *GameStop Corporation - VP of Public & Investor Relations*

I think we would like to know if it's just full-game downloads, if it's DLC, if it's digital currency. So there's some questions around that, that haven't been answered yet.

David Magee - *SunTrust Robinson Humphrey - Analyst*

Okay. Fair enough.

And then secondly, on the indie games, that sounds very interesting what you're doing with that. How is the pipeline potentially for that over the next couple years? Do you see a pipeline being big enough to really move the needle for GameStop?

Paul Raines - *GameStop Corporation - CEO*

Good question. Tony?

Tony Bartel - *GameStop Corporation - COO*

I do. As we shared, there's already a second game, Deformers, that is already in the pipeline. And I think what you're going to see this evolve into is a combination of games that we publish through Game Trust, and we're going to continue to do that. I think I talked about four games that we've announced, and we have others in the pipeline that we haven't announced yet. We have a good pipeline.

I think the other opportunity that we have, and what we've proved is that when you give something visibility in our stores -- and our stores are fantastic at marketing things to people and allowing them to afford things -- when you do that, you open up whole new markets. So I think not only are you going to see us sell games that we publish, but you're also going to see us bring visibility to games that are out in the marketplace that a lot of people don't know about.

Our people are experts at selling. We have PowerUp Rewards. We know what people like.

And so you'll see some higher investment opportunities, like we've done with Game Trust and what we've done with Deformers and what we've done with Song of the Deep. And then you'll see some low investment alternatives where we're really marketing these. There's still high-margin opportunities for us. So we're excited about not just the games that we are publishing, but also the other games that we will bring to market.

Paul Raines - *GameStop Corporation - CEO*

That's where all the growth is, right?

Tony Bartel - *GameStop Corporation - COO*

That's where all the growth is. It's a $1 billion plus, biggest to the largest piece, or one of the largest pieces of the digital industry, I think 5 times as large as full game downloads.

Paul Raines - *GameStop Corporation - CEO*

It's where all the growth is. That's why we're focused on it.

David Magee - *SunTrust Robinson Humphrey - Analyst*

Great. Thanks and good luck.

Paul Raines - *GameStop Corporation - CEO*

Thank you, David.

Operator

That will conclude the question-and-answer session. I'll turn it back over to Paul Raines for closing remarks.

Paul Raines - *GameStop Corporation - CEO*

Yes. Thank you. Thank you for joining us on the quarterly earnings call.

If we sit here and reflect, as we think about the decline in physical gaming of almost 40% from its peak in 2008 to 2016, our strategy of diversification has paid off in allowing us to reach the high end of our guidance this quarter, on our way to a record net income year that we're forecasting for this year. With all the great virtual reality and console expectations coming, we believe physical gaming will return to growth in 2017. In addition, our new growth businesses of Digital, Mobile, and Collectibles make GME a very compelling investment for the future, as we grow 3% to 5% annually to 2019, as we projected at our investor day.

We hope to see all of you at our annual store manager conference in Anaheim. I think Matt's had some invitations out to everybody, and we'll look forward to seeing you there on September 13, 2016. Thanks a lot.

Operator

And again, that does conclude today's conference call. Thank you all for your participation.