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GME - Q1 2016 GameStop Corp Earnings Call

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OVERVIEW:

Co. reported 1Q16 GAAP EPS of $0.63. Expects 2Q16 revenues to range between negative 4% and negative 1% and EPS to be $0.23-0.30. Expects full-year 2016 EPS to be $3.90-4.05.

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PRESENTATION

Operator

Good day and welcome to the GameStop Corporation's first quarter 2016 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'd like to turn the call over to Paul Raines, Chief Executive Officer. Please go ahead, sir.

Paul Raines - *GameStop Corporation - CEO*

Good afternoon and welcome to the GameStop earnings call. I want to thank our worldwide team for another great effort in the first quarter in delivering outstanding customer service. Joining me on our call today are Tony Bartel, our Chief Operating Officer, Rob Lloyd, our Chief Financial Officer, Mike Hogan, our Executive Vice President of Strategy and Business Development, Mike Mauler, President of International, and Matt Hodges, our Vice President of Investor and Public Relations.

We thank those of you who joined us at our recent Investor Day, and believe that our results played out along the lines we described. We introduced some new terms at that day, so if you were not there I will give you a primer on our new vernacular.

First, we've introduced the concept of GameStop branded stores to distinguish from our Technology Brands as well as our ThinkGeek stores. Second, we've introduced a reference to GameStop the Corporation as GME to distinguish the store brand from our overall corporate identity. Third, we introduced some new school metrics like gross profit comps and traffic comps to distinguish our new businesses from the old school metrics in our GameStop branded stores. And fourth, we established some new targets for our Digital, Collectibles and Tech Brands businesses.

Now let me start by giving you a few highlights from the quarter. Our Technology Brands business had [500%] plus operating earnings growth on 62% sales growth. Traffic comps 1%, and gross profit comps were 7%. We are pleased with our performance in the Tech Brands segment, and currently expect to close the two previously announced AT&T authorized resellers by the end of the second quarter. When completed, these two additional deals will bring our Technology Brands portfolio store count to approximately 1,500 stores in the AT&T, Simply Mac and Cricket formats.

Global comps in our video game business came in at a negative 6.2%, overlapping a positive 8.6% comp from last year in the first quarter in our Video Game business. As we described in the press release, we overlapped significant titles and also saw a shift of uncharted out of the first quarter. Pre-owned declined 3.7%, but still outgrew the new software category.

Our non-GAAP Digital sales increased 16%, continuing our growth trajectory in that space. Last but not least, our Collectibles business grew about 260%, proving that the category is vibrant and adjacent to our base. Top licenses and products for the first quarter were Five Nights at Freddy's, Pokemon, Minecraft, and Marvel.

We opened our first New York City ThinkGeek store earlier this month at 33rd and Broadway, and now have four standalone stores in the United States. You can see some pictures of that store in the supplemental deck. We also have 34 Collectibles stores overseas.

We have spent time following up with several analysts and investors since our Investor Day, and have had good dialogue on our strategy. The key point we made at our Investor Day is that our GameStop branded stores are increasing profitability over the last several years thanks to Digital, Collectible and omni-channel businesses we have developed inside them. We're not just a physical gaming store. On the Tech Brands side, we also have accelerating profitability in our core stores.

For those of you looking for a succinct external summary of our Investor Day event, the recent case study published by Forrester Research might be of interest to you, and it is available on our website. Their report summarizes the four takeaways we highlighted at our Investor Day. The first is that we have added a new $1 billion run rate business outside our core GameStop branded stores called Technology Brands with great growth prospects.

The second is that we added two $1 billion categories inside our GameStop branded stores. The first is Digital with a sustainable $1 billion non-GAAP revenue base, and the second is Collectibles which is well on its way to a $1 billion revenue line.

The third takeaway is that physical video gaming is cyclical, but has a very long tail and we have significant share in the category. Virtual reality and new consoles are a wild card in that business segment, and could dramatically change the growth projections. And the fourth takeaway was that all of these combine to make GME a growing and diversified company.

We reported record net income in 2015 for GME, and we continue to guide to record net income for 2016. For the second quarter, our guidance reflects the cyclical nature of the video game business as we await updates from E3. The second quarter is traditionally the low point of the year for video gaming, and we expect more of the same dynamic to play out on traffic and software and hardware growth. Our Digital, Collectibles and Technology Brands businesses will be significantly positive in the second quarter.

Remember that in the video game segment, we're overlapping an 8% comp last year and a 41% growth rate in our overall earnings per share in Q2 of 2015. Only two years ago, our Q2 earnings per share were $0.22. So the midpoint of our guidance reflects about 20% growth over the two-year period. We're excited about E3 and expect to hear major news on virtual reality as well as potential new consoles. These events have traditionally been a catalyst for GME shares, and Mike Hogan has done some modeling of potential impact that he will share with you in his remarks. Tony Bartel will also update you on our expectations for E3.

With that, I'll turn the call over to Rob Lloyd.

Rob Lloyd - *GameStop Corporation - CFO*

Thank you, Paul. Good afternoon, everyone.

We had a successful first quarter. We're pleased with our GAAP earnings of $0.63 per share at the high end of guidance, and our earnings of $0.66 per share excluding charges. The comps and earnings exceeded our guidance range, while sales were within our expectations.

Highlights include sales growth in Tech Brands of 62% to over $165 million. Tech Brands operating earnings of $18.8 million, compared to $3.1 million last year, a record for quarterly Tech Brands' profit. We are well on our way to our full-year guidance.

Growth in our Collectibles business of over 250% to $82.3 million in sales, again well on our way to a full-year goal of $450 million to $500 million. As you can see in schedule 1 to the release, we are now disclosing Collectibles as its own sales and margin category. It was previously included in other.

Consolidated gross margins were 34.3%, up 330 basis points from last year. 42% of our operating earnings in the quarter came from sources other than physical gaming. We will update on this new metric from quarter to quarter, however it will be volatile during the year as the video game business has more seasonality than Tech Brands. This metric will be most meaningful at the end of our fiscal years. Keep in mind that we expect 30% or more of our FY16 operating earnings to come from sources other than physical gaming.

At our Investor Day, I covered new school metrics and old school metrics. The numbers I just gave you are new school metrics. Margin expansion, growth in our new businesses, et cetera. Some of the old school metrics include a decline in hardware of 28.8% during the quarter, a decline in software of 7.6%, and a decline in pre-owned of 3.7%. The pre-owned margin for the quarter was 46.9%, in line with recent quarters as the mix continues to shift toward next gen pre-owned products.

Now for a little more depth. Sales decreased 4.3% in the quarter as expected. The FX impact on sales was $7 million for the quarter, therefore we will not distinguish our results excluding currency. Comparable store sales decreased 6.2% for the quarter, ahead of our guidance of down 9% to down 7%. US comps were down 6.6%, international comps were down 4.9%.

Gross margins were 34.3%, with expansion coming from the growth of Tech Brands. We incurred charges in the first quarter totaling $4.1 million relating to the final cost to exit Puerto Rico as we discussed on our last call. The charges were $2.6 million net of tax. Operating earnings were down 4.7% for the quarter, excluding the Puerto Rico costs. International operating earnings in Q1 improved $0.5 million over last year's first quarter.

SG&A as a percentage of sales increased from 23.3% in the prior-year quarter to 26.4% for this year's first-quarter. The increases were due to the decline in sales overall and the growth of Tech Brands, which as we've said in the past carries a higher SG&A rate. The increase in margin rate more than covered the increase in SG&A as a percentage of sales. SG&A in the GameStop branded stores declined slightly year-over-year, but increased as a percentage of sales from 22.1% in the first quarter of last year to 24.2% this quarter.

Interest expense increased by $5.4 million, due to the issuance of senior notes in March. Non-GAAP net income decreased $5.4 million or 7.3% for the quarter. Non-GAAP EPS decreased 2.9% for the quarter.

Now let's look at sales for some of the categories. Hardware declined 28.8%. The largest impact came from decline in 3DS comping against the launch last year; this decline was nearly half of the 28.8% decline. Next-gen units decreased 10.2%, and next-gen average unit price declined 8.4%. Software declined 7.6% in the quarter. The Division was a very successful seller, but comping against the combination of Battlefield Hardline and Mortal Kombat was very tough as each of those titles sold 1 million units.

Digital receipts increased 16.6%, due to the growth of DLC and bundled sales. GAAP Digital revenues declined 7.0%, primarily due to a shift in the types of Digital products sold and the margin rates of those individual products. Digital gross margin increased 4.5% over Q1 last year, with the margin rate reaching 86.4%.

Collectibles grew over 250%, with a margin rate of 34.8%. The decline in margin year over year is due to addition of ThinkGeek.com. Fulfillment costs for ThinkGeek impacted the category margin rate for the quarter by an estimated 200 basis points. We will move the ThinkGeek distribution operations from their third-party fulfillment center into our Louisville distribution center. This will be completed in early 2017, and will improve the margin rate.

Other key information includes that we closed a net of 63 video game stores, and now have 3,959 in the US and 2,024 internationally. We opened a net of 18 Technology Brands stores, and now have 1,054. We opened two Collectibles stores in the quarter. We did not buy back any shares in the first quarter. But as we showed on Investor Day, we plan to buy back between 75 million and 125 million this year.

Now I'll move on to second-quarter guidance. Revenues are forecast to range between negative 4% and negative 1%, with same-store sales ranging from down 7% to down 4%. The forecasted declines in hardware and software are the primary drivers of the negative comp.

Uncharted moving into our second quarter essentially offsets The Witcher from last year, but we don't have the titles to offset Batman Arkham Knight or the other strong titles from last year. As we look at the months in the quarter, we expect new software for the industry to grow in May, with Uncharted 4, Doom and Overwatch. We expect June and July to reflect an industry decline coming off of Batman and Elder Scrolls in June last year and Rory McIlroy PGA Tour in July.

Collectibles are expected to grow more than 90% from $41 million in sales in last year's second quarter. Tech Brands' sales are expected to grow more than 50% in the second quarter. The projected increase in operating earnings coming from Tech Brands and the margin from Collectibles are expected to offset the declines in video game product sales and operating earnings are forecasted to be flattish for the quarter.

We expect interest expense to increase by about $9 million from last year due to the additional debt. We expect earnings per share for the second quarter to be in a range between $0.23 and $0.30 per share. The projected decline from last year is due largely to the added interest expense. For the full year, we are maintaining our current EPS range of $3.90 to $4.05 and same-store sales range of negative 3% to flat.

As Paul mentioned, we expect to close the two AT&T reseller acquisitions by July 31. As we've said previously, we expect the projected earnings from these two deals to more than offset the interest expense from the date of the debt issuance. Given that we've seen a bottom-line impact from interest expense in Q1 and forecasted an impact for Q2, it is safe to assume that we will see accretion in the back half. We will clarify the projected impact on our next call once we have closed both deals.

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

Tony Bartel - *GameStop Corporation - COO*

Thanks, Rob.

This quarter showed the strength of our transformation strategy as Collectibles' sales and Technology Brands' profits more than offset the decline in physical video game sales, and as a result we exceeded our EPS guidance. In our non-physical businesses and GameStop branded stores we saw continued strength in both our digital and Collectibles business. In spite of a weaker game slate in 2016, we grew our console Digital receipts by 19%, keeping pace with industry growth. Our omni-channel Digital receipts grew 34%.

As we detailed at our Investor Day, we are also moving into other growth segments of Digital. On July 12, we will launch our first game trust published game, Song of the Deep, developed by Insomniac. We're seeing solid demand for this game in our stores, and believe that it will showcase our ability to make a market for great indie games.

We have several other games slated for release over the next year. In fact, next week, we will be announcing our second game under development with Ready at Dawn. As a reminder, as the publisher, we participate not only in the exclusive sale of physical discs by our GameStop branded stores, but we also participate in the profit from Digital sales of the game and related Collectibles regardless of where they are sold.

Also, we are expanding our in-store offerings for in-game purchases such as FIFA and Madden Ultimate Team, as well as expanding our sections for full-game digital downloads. As we shared at Investor Day, we expect to continue to keep pace with industry digital growth and expect full-game downloads to eventually settle in at the 25% to 30% range.

Our Collectibles sales continued to exceed expectations, growing at 261%. This growth was driven by expansion of linear feet especially in the US stores, the acquisition of ThinkGeek and the addition of several dedicated Collectibles stores. In 2016, we are adding 25 new ThinkGeek stores in the US and at least 25 Collectibles stores internationally. Given the importance of this category, we continue to increase the wall space that we are allocating to Collectibles and plan to increase the amount of dedicated space in the US stores by 40% by the end of the third quarter.

Turning to Technology Brands, we had a clean quarter with minimal transition costs, showcasing the profit potential that we will see this year. We grew Technology Brands' gross profit by 110% and operating profit by over 500%, through a combination of organic same-store profit growth, maturation of the stores that we built or acquired last year, and the absence of the conversion costs we incurred last year. Operating income margin was 11.3% in the quarter. Comparable Technology Brands stores increased traffic by 1% and gross profit dollars by 7%.

Due to strong promotional pricing on mobile devices, strong increases and integrated product sales of DirecTV and broadband, and stronger conversion. We continue to be the most productive authorized retailer in the AT&T system. Our average store count was up 106% over quarter one of last year. Reflecting aggressive growth that occurred during 2015, as we acquired stores, converted GameStop branded and RadioShack stores, and built widespace stores.

As we have previously disclosed, we will be closing two transactions in the second quarter keeping us on track to achieve our previous guidance of $85 million to $100 million of operating profit this year in Tech Brands. Which is growth of 200% to 260% over full year 2015.

As we shared at Investor Day, we have proprietary sales and operational programs that allow us to maximize the productivity of our Technology Brands stores. Resulting in increased productivity of 30% on average when we acquire a store. In addition, we're seeing strong growth in integrated products, DirecTV, broadband, and Digital Life as AT&T continues to increase support behind these initiatives.

Our physical video games decreased 14% and we rolled over more and stronger releases in 2015 than we had in 2016. Hardware was down 29% as we lapped 2015's successful 3DS launch. We continue to have dominant share in this category, and capture significant share at launch of new titles. In fact, we just sold our 4 millionth PS4 console in the US.

Our pre-owned business declined 3.7%, outpacing our physical video game decline by 10 points and outpacing the physical software decline by 4 points. As you can see on slide 10, we continue to outpace physical software growth on the new platforms, and are seeing less of a decline in pre-owned than we are in the previous gen physical software.

Our trade performance exceeded our expectations in the first quarter, so our inventory position is strong. With pre-owned inventory in the important Xbox 1 and PlayStation 4 categories up 47% over last year.

We expect E3 to focus on key titles in the back half of the year in console announcements. We also expect VR to generate significant gaming consumer and press interest. As discussed in Investor Day, we expect to be the preeminent launch partner for VR headsets to the gaming population as we leverage our proprietary PowerUp Rewards relationships and our buy-sell-trade model.

In closing, our transformation strategy is working and we continue to fill our GameStop branded stores with high-growth properties and expand our Tech Brands business at an aggressive pace. I would now like to turn the call over to Mike Hogan.

Mike Hogan - *GameStop Corporation - EVP Strategy and Business Development*

Thanks, Tony. I will cover two topics this afternoon. The first is a little color regarding the Collectibles category overall, and the factors driving GameStop's 261% growth in Q1. The second is an update on virtual reality and the new Nintendo console and their potential for driving growth in the physical gaming category.

As we noted at our April 14 Investor Day, Collectibles narrowly defined is an $11 billion category in the US, and estimated $18 billion globally. This is a growing but extremely fragmented category with no leader. We believe GameStop plus ThinkGeek can quickly become the market leader. We know that 45% of our PowerUp Rewards members already purchase Collectibles, and at an average spend of $360 per year, they represent up to half of the total category spend. Thus giving us the advantage position in this category.

We continue to see extremely strong performance in our Collectibles business. We are very much on track to achieve our goals of $450 million to $500 million for 2016, and $1 billion by 2019. At present, we have only about 2% to 3% share of this category, but we believe we can grow that dramatically. And keep in mind that $1 billion in 2019 would represent only about 5% to 6% of what will by then be a $16 billion US category.

As Rob noted, our Q1 sales of $82.3 million compared very favorably versus $22.8 million for Q1 of 2015, representing 261% growth year over year. The business can be thought of in terms of three channels. Our GameStop branded stores around the world, dedicated Collectibles stores, and the online business. Each of these channels experienced significant growth year over year. Our dedicated Collectibles stores are exceeding expectations, and we continue to expand rapidly. Globally, we now have 37 dedicated Collectibles retail stores and our plan is to add at least 50 more by year end.

In our GameStop branded stores, we continue to see strong acceptance of Collectibles by our existing consumer base. We have had great success in attaching incremental Collectibles purchases to video game titles such as Fallout, Star Wars, and Pokemon. Based upon this performance, we have increased the space dedicated to Collectibles in our stores.

Year-over-year Collectibles sales in GameStop branded stores is up over 200%. This is helping to fuel the continued increase in per-store profitability as we discussed in our Investor Day. And of course we added ThinkGeek.com to the mix, which continues to drive overall positive performance.

As we explained at Investor Day, our strategy is to implement an integrated marketing calendar leveraging the most significant events, movies, video game launches and other properties to drive continual product news and ongoing consumer interest and frequency. To date, this strategy is working well. For example, in the first quarter, we capitalized on key movie releases such as Deadpool and Captain America with a broad selection featuring dozens of products in store and online. We leveraged PowerUp Rewards to attach Collectibles on key game releases.

This includes Q1 releases such as Street Fighter, but also long tail sales from 2015 titles such as Fallout and Five Nights at Freddy's and even older titles such as Minecraft. We saw strong sales from enduring properties such as Star Wars, Dr. Who and Batman. And finally, we executed successful in-store events around relative occasions such as Valentine's Day and May the Fourth Be With You. The Collectibles business is proving to be a broad-based business, with many significant IT drivers across movies and TV, comics, video games and pop culture.

From a category perspective, we expanded our product lineup into new areas. Some of the most significant new areas of focus are apparel, where we expanded watches, socks and backpacks and grew more than 200%. And interestingly, housewares, where we also grew over 200%. The largest category continues to be toys which also grew over 200% versus prior year.

Looking ahead, we see a strong lineup of events and properties for the rest of the year. On the movie front, obviously Star Wars Rogue One is big focus for us. We also have plans around the new Harry Potter movie, Fantastic Beasts and Where to Find Them, and from DC comics the movie Suicide Squad. Key video game launches for Collectibles include Pokemon Sun and Moon, Battlefield, Call of Duty, Final Fantasy XV and South Park, and of course Game of Thrones as well.

In short, 2016 is shaping up as a very full calendar of compelling IP, whether movies, video games, TV or pop-culture. We feel like we're ahead of the curve in terms of bringing the right exclusive products at the right time, and leveraging PowerUp Rewards to message the right opportunity to each member.

Now a few words on the physical video game category outlook, and the potential impact of virtual reality and a new Nintendo console. Back in April at Investor Day, we shared a financial outlook through 2019 that incorporated a modest decline in the physical games business. At the time, we noted that those numbers did not include any new console launches and did not include any sales for virtual reality hardware or software.

I want to take a minute to lay out some category data that may help quantify the potential impact that these new innovations may have on the physical console gaming category in the near future. Specifically, I want to look at virtual reality products announced for 2016, and a new Nintendo console announced for 2017. We're not speculating on any new Microsoft or Sony consoles at this point. GameStop has not modeled or projected the impact of either of these innovations, we are simply looking at historical data and third-party projections. We will update this information each quarter, and later this year we will provide formal projections once we have more consumer data and initial sales data.

Let's turn to page 16 in the attached slide deck. The green bar on the left represents the physical gaming category's sales for the US for 2015, which totaled $13.1 billion. Moving over to the two orange bars, we can see two external projections for VR sales from Super Data and IDG. These bars represent the projections for launch plus the first two years, which in this case would be 2017 and 2018.

Their projections range from a low of $6.9 billion to a high of $13.6 billion. When added into a $13 billion category, you can get a sense of just how significant the impact could be on physical gaming sales. We are particularly excited about the Sony VR product given the attractive price point, the large installed base, and its plug-and-play capability.

Now let's move over to the blue bars on the right. Back at Investor Day, we illustrated the potential impact of new console introductions by all three manufacturers through 2019. Since then, Nintendo has confirmed that they will be introducing a new console in early 2017. So let's take a look at the potential for just that one new console. Once again, we are not projecting, we are simply looking at the potential for a new console in comparison to prior consoles.

Should the new NX perform only slightly better than the Wii U, it would still generate $2.7 billion of incremental sales over the first two years. Should it perform at even half of the level of the Wii, it would generate $7.5 billion in incremental sales over that timeframe. You can of course apply GameStop's average market share to estimate the impact on GameStop sales. While it is too early to offer definitive projections, we are monitoring this situation closely in terms of product availability and features, consumer awareness and purchase intent. We plan to provide an update each quarter.

I will now turn the call back over to Paul.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Mike. And with that, we will open it up for some questions and answers.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Mike Olson, Piper Jaffray.

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

Good afternoon. I had a few questions for you.

You beat gross margin nicely again this quarter, and I would guess it's somewhat hard to say what the trajectory of gross margin will be going forward given the pace of growth for Tech Brands could be impacted by acquisitions, et cetera. But is there anything you can say about where you would expect gross margin to be for the full year, and how much you think it will grow annually going forward for the next few years?

And then secondly on VR, it seems like it would be the case, this is probably obvious, that gamers would want to see firsthand and try VR in store. But do you have any evidence to show that that really is the case? Or is there the risk that gamers simply buy VR add-ons online? Thanks.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Mike. Let's start with number two. Tony and Mike Mauler, do you want to talk about what you're planning on doing with VR in store?

And we certainly have seen that that is a big part of conversion. All the research from Sony tells us that, but do you want to -- ?

Tony Bartel - *GameStop Corporation - COO*

Absolutely. And for those of you that were at Investor Day and were able to view that, we had Sony there and they articulated that a major part of their strategy is to make sure that people are able to experience that. And that's what we have seen. As people experience this complex device, it really becomes real to them, and so we plan on literally having hundreds of stores that will have VR capability.

In fact, that's what we have seen with the HTC byproduct that we have been demonstrating and have sold. And we've just expanded that from 10 stores to 100 stores. And you will begin to see us roll out as it gets closer to PlayStation VR as well.

So it's a complex product, and it takes a lot of explanation. And as we said at Investor Day, there will be nobody that is better informed or more able to meet the needs of the gaming customer than GameStop for that roll out.

Paul Raines - *GameStop Corporation - CEO*

Mike, you've got a heavy Sony penetration in Europe. What are your thoughts?

Mike Mauler - *GameStop Corp - President of International*

We do as well. As Tony said, we're going to see all of our larger stores have VR demos in the store. But also in stores that can't support that, we'll see a big events in the malls, in front of our stores, and so our intent is really in all the major markets that we're in to have strong demos and events.

Paul Raines - *GameStop Corporation - CEO*

Great. Rob, do you want to tackle the gross margin question?

Rob Lloyd - *GameStop Corporation - CFO*

Sure. I talked briefly about the seasonality of GameStop stores being different than those of Tech Brands, and so that's going to impact the gross margin rate as we move through the quarters. And we'll continue to see expansion, probably greater expansion in the early quarters of the year like we did in this first quarter, with it settling back down in the fourth quarter when the video game business has such a seasonal ramp up.

But overall, we see expansion coming for the year. And as we continue to grow the Technology Brands in the future, I would expect that to be the case, although perhaps at a moderated level. These increases we showed this quarter obviously would be tough for any business to sustain.

Paul Raines - *GameStop Corporation - CEO*

And just as a reminder, everyone, we showed a slide at Investor Day. We have expanded gross margin rates at GameStop for the last four or five years by 300, to 400, to 500 basis points. So those are aggressive, and don't know if we can reproduce them but we're in more accretive categories so.

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

Thank you.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Mike.

Operator

Brian Nagel, Oppenheimer.

Dan Farrell - *Oppenheimer & Co. - Analyst*

This is Dan Farrell on for Brian Nagel. You guys have shown a pretty good ability to grow the Collectibles category so far, I just was wondering, kind of a bigger picture question.

Do you think the growth is more of an initial market share gain or an expansion of the overall market or a mix of both? And then if you had any initial takeaways from the early openings of the ThinkGeek stores.

Paul Raines - *GameStop Corporation - CEO*

We have got both Mike Hogan and Mike Mauler here. Just one comment, if anybody hasn't been to 34th and Broadway, please go.

It's in the first floor of our two-story store there, so there's a GameStop in the second store. Go downstairs, it's a stunning store and you should go check it out. I think it says a lot about how we are expanding it. Let's start maybe, Mike, do you want to talk about the history of how we got into this, and then, Mike Hogan, do you want to talk about the depth of the category?

Mike Mauler - *GameStop Corp - President of International*

Sure. As we discussed, we started piloting this category about four years ago in Australia. And I think we continue to see it grow. So right now what we're seeing, I think the market is growing as Mike said earlier and he can expand on that.

And we're also taking a lot of share in a very fragmented market. And we are taking share by improving our merchandising, by improving the space. We have in the store have dedicated the category, and we're working closely with on the video game side our vendors to make Loot part of the new release launch.

Working now with IP holders for movies and television shows to have better product offerings, expanding our omni-channel through ThinkGeek as well who's playing a role in this. And I would just finally add in Australia now, they're entering their fifth year of Loot, and their in-store Loot sales are still growing at double-digits. So it is a category that has a lot of interest (inaudible).

Mike Hogan - *GameStop Corporation - EVP Strategy and Business Development*

I would just add, Mike mentioned it was fragmented category. This is a category with relatively low awareness overall, and I think we should expect to see strong category growth and strong consumer penetration growth for quite a while to come.

The second thing I would say is, a lot of the products we're selling are unique products that aren't available anywhere else. One of the biggest selling products that ThinkGeek created last year was a physical product to go with the game Fallout. So bringing the digital reality into the physical world. And so we have more and more products that we're creating that are coming to the market for the first time.

And so then the third thing I would say is with PowerUp Rewards, we've been able to reach out directly to our PowerUp Rewards members. Not just to attach with video games, but relative to other titles and other occasions that make sense for folks. For example, a big Star Wars theme around May the fourth. So we are seeing a growth in purchases per individual PowerUp Rewards member as well.

Paul Raines - *GameStop Corporation - CEO*

And there's new entrants into this category. So for example, we are the official launch partner of Funko's new League of Legend licensed products. So this is the first time that League of Legends by Riot games is going to put physical product into retail.

So I think we're finding people who did not know this was an opportunity, customers who did not know they could actually express their favor, their love of an IP, et cetera. So we think it's got a lot of growth.

Dan Farrell - *Oppenheimer & Co. - Analyst*

Great. And then I have a quick follow up if I may. In Q2 with the lapping of some stronger new video game releases in the prior year, going into the next quarter, can you talk about your expectations for pre-owned growth given that some of the expectations for new software sales are more subdued?

Paul Raines - *GameStop Corporation - CEO*

Sure. Tony, you want to talk about that?

Tony Bartel - *GameStop Corporation - COO*

Sure, Dan. Given the fact that we have strong inventory position and like we shared at Investor Day we have detached from the overall video growth rates, so we would expect it to continue to significantly outpace the physical video game market.

Dan Farrell - *Oppenheimer & Co. - Analyst*

Would you expect it to moderate as it did in Q1, or would you expect an expansion?

Tony Bartel - *GameStop Corporation - COO*

I think at this point we would expect it to be flattish versus a decline in the physical (inaudible).

Paul Raines - *GameStop Corporation - CEO*

We're still committed to our overall annual guidance of minus 2% to plus 2%.

Dan Farrell - *Oppenheimer & Co. - Analyst*

Great, thanks, guys.

Paul Raines - *GameStop Corporation - CEO*

Thank you.

Operator

Colin Sebastian, Robert Baird.

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

Thanks, guys. Congrats on a good quarter.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Colin.

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

Sure. First off on looking for a little more detail on Overwatch. (Technical difficulty). And then secondly, probably to Rob, but SG&A, wondering how we should think about that over the course of the year, and how you are perhaps able to extract the cost efficiencies even as you are expanding format and store locations?

Paul Raines - *GameStop Corporation - CEO*

Great. The SG&A is timely, we've been working on that, we met on that today. But let's let Tony start, and maybe Tony and Mike Mauler start with Overwatch

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Tony Bartel - *GameStop Corporation - COO*

Sure. Overwatch exceeded our expectations, and it was a very strong launch for us. And let me share with you something that you may not know on this. It was actually a very progressive move by one of our strong partners, Activision. They looked and saw that there was a demand before the game, before the midnight launch, to be able to get the physical game.

They saw that people were in some cases digitally downloading the game. But what they did is said, hey let's go ahead and see if they -- let's go ahead and give them the physical game before the midnight launch, and then we'll turn on the servers. Because it's become less about picking up the game at midnight, it's become more about when do the servers come on.

And what that did was allow us to have two full days before the servers came on to sell that game, and what we saw was a significant increase well beyond our expectations of Overwatch. And I think Activision would say that they saw an increase as well, and we're very happy with the results. So we see that as a very progressive move, and something that we think may take hold in the industry as well.

So that's what we saw in the US. And, Mike, you want to share your experience in international?

Mike Hogan - *GameStop Corporation - EVP Strategy and Business Development*

Yes, I think we saw the same thing internationally. Even to a greater degree due to the slower download speeds. Activision was a great partner on this title, and it exceeded expectations.

I think what happens when the publisher tries to force a digital preference by making just a piece of their offering early, it puts them at a disadvantage and really it's all about customer choice. And it hurts the customer as well, and that results in less reservations and sales for a title like that. So what Activision did, as Tony said, was really progressive and with phenomenal results.

Paul Raines - *GameStop Corporation - CEO*

That is great. It's always -- the thing about this digital thing, Overwatch was a great title for us. And the thing about it is you have to be insightful about what consumers want, not really pushing your own agenda but more what consumers want. Rob, do you want to talk about SG&A?

Rob Lloyd - *GameStop Corporation - CFO*

Sure. So Colin, as we've talked about, the SG&A on the Tech Brands is higher than it is on the video game business and the GameStop branded stores. So as we grow that business throughout the year, you can -- you will see an increase in SG&A as a percentage of sales but what we'll deliver to you as we report our results quarterly, is what is happening overall as well as what is happening in the GameStop branded stores. We talked about on Investor Day that we're taking costs out of the core business, and we'll be able to report against that.

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

Thank you.

Paul Raines - *GameStop Corporation - CEO*

Thanks, Colin.

Operator

We have time for two more questions. David Schick, Consumer Edge Research.

Ray Stochel - *Stifel Nicolaus - Analyst*

Hi, guys, this is Ray Stochel on for Dave. Good afternoon. What level of insight can you share on rumors the new Nintendo console is shifting from disc-based games to cartridges? And if you can't specifically comment on that, can you discuss any historical economic differences between cartridges and discs for the pre-owned business?

Paul Raines - *GameStop Corporation - CEO*

We saw those rumors, and so obviously we can't comment on them. I don't think we know anything about it anyway.

But certainly for us, physical media is a good thing, right? As far as the historical, guys, anybody have any thoughts on that?

Rob Lloyd - *GameStop Corporation - CFO*

I don't remember anything distinctly different between economics of pre-owned whether or not it was disc or cartridge based. Mike, do you?

Mike Mauler - *GameStop Corp - President of International*

The only difference would be on the refurbishment and pre-owned side. And actually, cartridges are much simpler to refurbish and repackage. So there is somewhat a little bit of an advantage if it went in that direction on used.

Paul Raines - *GameStop Corporation - CEO*

But it is early, guys, and we have got to all keep cool heads. Certainly I would say that the fact that there are rumors of that type just confirms for you that this is an important console for next year. It will have physical media, we will play a role in it, our pre-owned business will also play a role. So we're excited about that.

And of course we love Nintendo IP. So it's all good news.

Ray Stochel - *Stifel Nicolaus - Analyst*

Absolutely. That is great. And then just the follow up on the other newness in the category. So what are you seeing now from PowerUp Rewards members that you are surveying certainly about virtual reality? And that's it.

Paul Raines - *GameStop Corporation - CEO*

Okay, Mike?

Mike Hogan - *GameStop Corporation - EVP Strategy and Business Development*

Yes. So we continue to see pretty strong interest. I think one of the things that we saw that we shared at Investor Day is we put out what information we've had. We've already had over 1 million PowerUp members express interest in these products.

I think at this point, we would describe the interest is pretty -- the awareness is strong, the interest is growing. And what people are doing is they're willing to come and understand what products are available, they're wanting to understand what games are available with those products.

So we expect to have all through the fall, we'll have a great opportunity to do a lot of education of people. I would say there's a lot of people who are of interest -- are interested at this point, not that many of them know exactly what they're going to buy yet. So they're going to be looking for more information as it comes out, and obviously we want to be the ones to give it to them.

Ray Stochel - *Stifel Nicolaus - Analyst*

Great, thanks so much.

Paul Raines - *GameStop Corporation - CEO*

Okay.

Operator

Curt Nagle, Bank of America.

Curt Nagle - *BofA Merrill Lynch - Analyst*

Thanks very much for taking the question. Just a quick question or a follow up I guess on VR. How are pre-orders trending relative to expectations?

And then just a follow up, what was free cash flow in the quarter? How much of the inventory was due to pre-owned, the increase, and then are you still expecting $400 million to $500 million for the year?

Paul Raines - *GameStop Corporation - CEO*

Okay. Tony, you want start with VR?

Tony Bartel - *GameStop Corporation - COO*

Sure. VR, we are full of pre-orders. So we took all the pre-orders that we could, they went out very quickly. Now we're filling up our first-to-know list on the devices, so that we can go out and tell people things like whenever news comes out we will be able to tell them, about what that news is.

When we get a new allocation of pre-orders, we'll be able to put that back up. So, like Mike shared, we've had 1 million people express interest (inaudible).

Curt Nagle - *BofA Merrill Lynch - Analyst*

Did you say 1 million?

Tony Bartel - *GameStop Corporation - COO*

Many of them have come on for our first-to-know list, so we're communicating with them a lot of the time. So we [sigh], and I think it's only going to grow after E3.

Paul Raines - *GameStop Corporation - CEO*

So that does not mean we're allocated 1 million units. I wish we were. We can't disclose our allocation, but it's significantly less than that.

But 1 million people on the first-to-know list is a pretty significant interest level. So I would say that is healthy. Rob, free cash flow and increase in inventory?

Rob Lloyd - *GameStop Corporation - CFO*

I don't have the free cash flow for the quarter in front of me. We typically disclose that in the cash flow statement included in our 10-Q. We are not revising our free cash flow estimates for the year at this time.

And with respect to inventory at the end of the quarter, there were probably three things that happened. We did see a healthy increase in our pre-owned inventory, and we were intentionally building that. We had inventory on hand for the titles that launched in early May.

So you get the inventory in advance of the launch, which affects the inventory number at the quarter but unfortunately you don't get any of the sales yet. And then growth of Technology Brands also created year-over-year inventory growth.

Curt Nagle - *BofA Merrill Lynch - Analyst*

Okay, thanks very much.

Paul Raines - *GameStop Corporation - CEO*

Thank you, Curtis.

Operator

That concludes today's question-and-answer session. At this time, I'll turn the conference back to Paul Raines for any closing remarks.

Paul Raines - *GameStop Corporation - CEO*

Great, thank you very much. Appreciate everyone attending our call today. We look forward to your interest in E3, and talk to you on the next call. Bye-bye.

Operator

This does conclude today's conference. Thank you for your participation. You may now disconnect.
