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GME - Q4 2016 GameStop Corp Earnings Call

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OVERVIEW:

Co. reported 4Q16 results. Expects FY17 revenues to range between down 2% and up 2% and EPS to be $3.10-3.40.

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PRESENTATION

Operator

Good day and welcome to the GameStop Corporation's fourth-quarter and full-year 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 would like to turn the call over to Paul Raines, CEO. Please go ahead, sir.

Paul Raines - *GameStop Corp. - CEO*

Thank you. Good afternoon and welcome to the GameStop earnings call. I want to thank all our global associates for your outstanding service to our customers in 2016. Navigating transformation takes a full team effort, and I am extremely proud of how our organization has built an even stronger culture throughout the year.

Speaking on the call today will be Rob Lloyd and Tony Bartel. Also in the room are Mike Hogan, Mike Buskey, Mike Mauler, Jason Ellis and Matt Hodges. 2016 proved to be a more difficult year than we originally forecast. While our strategic transformation drove record gross margins of 35% and earnings came in within our revised guidance of $3.77, we encountered stiff headwinds as we completed the third year of the console cycle. As a result, the physical games category declined 15% and our GameStop brand lost a small amount of market share during the holiday period due to deep discounting.

Our internal model, which aggregates PwC, DFC and IDG, forecast only a 5% decline. And even as late as September, experts were still expecting a 5% decline for the year. However, according to NPD, excluding Pokemon, the top eight physical software titles actually declined over 40% from October to December compared to the top eight released in the same timeframe in 2015.

As a result, most publishers began discounting titles much earlier than previous years, leading to a steep decline in retail pricing. The 2016 holiday was also more promotional than prior ones, with average hardware prices down 15% versus prior years. That decline reflected the impact of all the below-cost discounts and complementary gift cards that we saw from Black Friday that ultimately carried through the holiday season.

Mid-console upgrades were also not as meaningful as we had hoped. Some have argued that this decline was caused by title fatigue. Others have argued for a need for new consoles. And, looking more broadly across the general retail spectrum, it was obviously a transformational holiday season for a number of hard-line retailers. It is also encouraging, though, to see what was not a primary cause of physical declines. We know from various external sources that the penetration of full game downloads increased 2 to 8 points in 2016.

Remember that we have mid-single-digit share on full game digital downloads and an overall 18% share for console digital products, including full game downloads, downloadable content, digital currency and PC. Our conclusions are that overall gaming declined slightly in 2016 as mobile growth slowed and console digital was flat. So, I think it is critical for our analysts and investors to understand that 2016's physical game declines were not caused solely by acceleration in full game downloads. Now, despite the physical decline, based on our research within our gaming community, the majority of gamers' purchase intent for new consoles is high, with more than 50% of nonowners still planning to upgrade to a PS4 or Xbox One.

Purchase intent for Switch and Scorpio is at PS4 levels or higher. Just a note on the Switch launch: we have had a very successful launch so far with high attach rates of software, particularly Zelda and related add-ons. The Switch has provided a dramatic lift in traffic in store and has real potential to be Wii-like in its ability to expand the gaming category from core to broad audiences. In fact, the Wall Street Journal reported late last week that Nintendo could potentially double their original output forecast over the next 12 months.

As for now, we continue to receive more allocation, strengthening what we believe is already leading market share. We are also looking forward to the launch of the Switch title from GameTrust called Has-Been Heroes, which recently won an award at PAX East as best handheld game.

GameStop has an extensive loyalty CRM program, known as PowerUp Rewards. In 2016 our PowerUp members drove 71% of our sales volume in the United States, so they are very important to us. In addition, they spend roughly six times that of a nonmember and three times that of a basic member. We have recently strengthened our PowerUp Pro program with richer rewards and better focus in our stores and website. As a result, we grew our membership base in 2016 and they are rewarding us with greater frequency and larger average purchase. Historically, growth in PowerUp awards brings us great benefits. And if you are a PowerUp Pro member, you know that the Pro Gaming Pass, Pro Days and exclusive offers are a few examples of new value for your membership.

Shifting gears, let's talk about one of the great growth stories we had in 2016, our collectibles business, which hit the high end of our revenue guidance at $494 million. We are spending a lot of time on the collectibles business, driving global best practices, buying synergies, developing standalone collectible stores and hybrids, as well as integrating thinkgeek.com into the enterprise. We are very focused on continuing to grow this area and the availability of licenses from IP holders and movie studios will continue to support that growth. In 2017, we expect to grow our collectibles business by 30% to 40%.

tech brands was another great growth story in 2016. Revenue grew 52% for the year to $814 million as we added a net 486 stores, to become AT&T's largest dealer. We continue to be closely aligned with AT&T and see their diversification as an asset to us as we continue to support their initiatives. Tony Bartel will provide color on our key activities for the tech brands business, but it's safe to say that we look for more great things out of this business in 2017. So, despite the strength of our new businesses, some of you may still be asking, is your strategy working? Our answer: it absolutely is. To help you see this more clearly, let's revisit the four pillars we presented to you at our spring 2016 Investor Day.

In physical gaming there have been cyclical declines, without question. But we have very strong cards to play in Nintendo Switch, Sony VR and Microsoft Scorpio. We have also demonstrated our ability to proactively and intelligently right-size our footprint and to reduce the in-store linear footage to give us more room for collectibles. This ability to flex in response to the marketplace is one of our key assets as we continue to transform the business. Digital is another growth segment, with digital receipts growing 4% to $1.1 billion in 2016. Growth was driven by a 20% increase in DLC and Kongregate sales. We expect to continue to be a strong participant in this area and post steady gains over the long-term.

Collectibles is an absolute win and has great potential for future growth. As we double our internal linear footage within GameStop branded stores, we expect to see continued growth along with thinkgeek.com productivity in our websites and standalone stores. Collectibles is on track to become a $1 billion business by the end of 2019. In technology brands we continue to have high expectations as we cycle growth of our latest acquisitions and see new products from AT&T. Tech brands is still on pace to generate $200 million of operating earnings in 2019.

In terms of capital strength, we continue to generate significant cash flow and we are reducing capital expenditures to reflect a smaller business. This discipline has allowed us not only to produce outstanding cash flow but also return that capital to shareholders generously and consistently. Therefore, we believe that our strategy is sound, as we will continue to proactively navigate any and all consumer shifts on the physical gaming side of the business and aggressively diversify through our strong non-gaming categories.

In 2008, we were a 100% physical retailer, and last year we had 37% of our earnings coming from nonphysical businesses. Why do we think that is important? Simply because that derisks your investment in GME while providing shareholders with the upside of the frequent cycles in gaming. As we grow our nonphysical assets of digital, collectibles and tech brands, we believe the value in our collective franchise will prove much higher than it is today.

A further word on capital policy, and I will ask Rob to provide more color when he walks through his prepared remarks. We have had a strong commitment to returning excess cash to investors in recent years, reflected in our rich dividend and $2 billion of share buyback activity. This year, we have already increased the dividend on our shares and we will continue to evaluate the best capital allocation levers to pull to create value as we move forward, balancing dividends against the maintenance of a strong balance sheet, investing in our business and future share buybacks.

On the growth front, we are aggressively redirecting capital investment to our growth, including omni-channel, PowerUp Rewards, thinkgeek.com integration and indie games. Our tech brands and collectibles will receive investment as well. We believe we are firmly grounded in doing the right thing for shareholders on all fronts. We have also changed our guidance policy, moving to an annual guidance model. We will, of course, report quarterly earnings as we always have, but would like to set our sights more longer-term. We think it is a responsible approach to guidance.

In closing, I have to share a comment I made on this earnings call a couple of years ago. I quote, it is interesting; when we first started out driving a high rate of internal change here at GameStop a few years ago, we had no idea how rapidly our external space would change. The good news is that we have persevered and today find ourselves with an abundance of good business opportunities as we build a portfolio of specialty retail brands that make your favorite technologies affordable and simple, end quote.

We continue to stay consistent with our strategy we covered with you in our analyst update from 2016. While our category continues to change, we think that GME has the correct strategy to diversify and weather cycles in the physical gaming category while building on growth in digital, collectibles and technology brands. With that, I will turn the call over to Rob.

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

Thanks, Paul. Good afternoon, everyone. Today I'd like to take you through a review of our Q4 and full-year 2016 results and our 2017 guidance. Overall, as Paul said, our financial results met our most recent guidance. Sales decreased 13.6% in Q4 and 8.1% for the full year. Comparable-store sales decreased 16.3% for the quarter and 11.0% for the year. US comps were down 20.8% for Q4 and 13.5% for the year.

While the gaming business had its challenges, our non-gaming business continued to grow and provided more validation for our business transformation. Tech brands' revenues grew 43.9% in Q4 and 52.4% to $814 million for the year. We also hit the high end of our collectibles target of $450 million to $500 million with $494 million in sales. Gross margins expanded 350 basis points for the quarter to 33.1% and 380 basis points for the year, resulting in a 35.0% margin rate, which is a record annual gross margin rate for GME. Gross profit for the year grew 3.1% to a record $3.0 billion.

During the fourth quarter, we took charges totaling $56.5 million on a pretax basis and $35.1 million after-tax for asset impairments in store closing-related costs. More specifically, we impaired $10.5 million in intangible and store assets in the videogame store base. $46 million of the charges were in the technology brands division. After four years of rapid expansion, we took some aggressive moves related to the consolidation of the store portfolio.

Charges related to AT&T stores totaled $27.5 million and were primarily associated with stores acquired in last year's large dealer acquisitions, or for former RadioShack locations. The remaining $18.5 million of the charges were related to Simply Mac stores which were not profitable, due in large measure to a lack of product allocation and channel conflict. Many of these stores were closed in January or will be closed in 2017 as leases expire.

Adjusted operating earnings fell $45.4 million or 11.7% for the quarter and $47.4 million or 7.1% for the year, due to the decline in sales and resulting margin, while SG&A increased as we grew the tech brands store count. We did, however, report our third consecutive year of improved operating margin, reaching 7.2%. In Q4, tech brands' operating earnings, excluding charges, increased 89% from $18 million in Q4 last year to $34 million. We guided to $85 million to $100 million of operating profit in tech brands for 2016 and achieved $90.2 million, excluding charges.

As you've heard, our goal is to have 50% of our operating earnings come from sources other than physical gaming by the end of 2019. In 2016, we had 36.9% from sources like digital, collectibles and tech brands, so we remain on pace to achieve that goal. As we discussed in the holiday sales release, our tax rate was lower than normal for the quarter and the year due to our tax planning efforts in certain of our foreign operations. The resulting tax benefit was $27.3 million in the fourth quarter. Adjusted net income for the year was down 6% to $391 million and full-year adjusted earnings per share were $3.77, down 3.3%.

Now I will dig in a bit deeper, starting with the videogame business. Hardware sales declined 29.1% in Q4 due to an 8% decline in units sold and a 25% decline in average selling price. For the full year, hardware sales declined 28.2% due to midteens percentage declines in both units sold and average selling price. Software sales declined 19.3% in the quarter and 14.2% for the year. As we discussed in the holiday release, the key titles for the quarter did not perform well.

Preowned revenue was down 6.7% in the quarter and 5.1% for the year. Preowned margin rates for the quarter and full year were 46.9% and 46.3%, respectively. The Q4 margin rate was up slightly from last year's Q4. For the full year, the margin rate was down 60 basis points from the prior year. Accessory sales declined 17.4% during the quarter, following the trend of hardware. However, accessory sales outperformed the other game categories, down 3.7% for the full year due to the impact of the VR. Digital receipts declined 7.7% in the fourth quarter, with GAAP digital revenues declining 5.8%. For the year, digital receipts grew 4% and GAAP digital revenues declined 3.9%, primarily due to a shift in mix caused by the launch of games on Kongregate.

Tech brands' revenues grew 43.9% in the quarter and 52.4% for the year, due to store count growth. Tech brands' margins were 68.2% in the fourth quarter and 68.1% for the year, up from 57.4% in 2015, as the AT&T business continues to grow within the tech brands mix. Collectibles hit $494 million in sales with a 34.7% margin for the year. As we have mentioned previously, the margin rate was impacted by distribution costs for thinkgeek.com. I am pleased to report that we have eliminated the third-party logistics provider and are now poised for improved margins in 2017.

SG&A as a percentage of sales increased from 17.4% in the prior-year quarter to 21.2% for the quarter and from 22.6% in the prior year to 26.2% for 2016. The increases were due to the decline in sales overall and relative to growth of tech brands, which carries a higher SG&A rate. We were successful in cutting over $32 million in SG&A from our core business, exceeding our target for 2016 of $30 million. The cuts came in store expenses, including payroll, and in infrastructure and back-office costs. We are on track to remove $100 million of SG&A costs by the end of 2017.

In 2016, we closed a net of 119 videogame stores around the world, ending the year with 3,920 videogame stores in the US and 2,007 internationally. We acquired 511 technology brands stores, opened another 72, and closed 97, for a net growth of 486 stores and a year-ending store count of 1,522. We opened a net 51 collectible stores during the full year and now have 86.

In 2016, we paid out $155.5 million in dividends and repurchased $75.1 million in stock or 3.0 million shares at an average price of $24.94. We generated free cash flow of $400.3 million. Lastly, we completed several acquisitions for a total of $441 million, adding 511 stores to our technology brands division.

Now I'd like to talk about the shift in our guidance policy. As you know, we're on a multiyear journey to transform our business. In support of this, we've made the decision to stop providing quarterly guidance for earnings per share and same-store sales. This decision does not reflect a lack of visibility into the short-term environment, but rather our desire both internally and externally to remain focused on longer-term targets and performance. We also hope to reduce quarterly volatility that is driven by the seasonality and title-driven nature of the videogame industry, as well as the EPS volatility created by the significant reduction in our share count over the last few years.

Given our transformation, the quarterly comparisons of title launches no longer reflect the long-term value drivers for our business, especially as we expand our non-gaming store footprint and drive growth in higher-margin categories. We will continue to offer some quarterly insights and context as appropriate, the content of which may vary from quarter to quarter depending upon what may be relevant. We will provide annual guidance, which I will now cover.

For fiscal 2017, full-year revenues are forecasted to range between down 2% and up 2%, with same-store sales ranging from down 5% to flat. We are forecasting hardware sales to be roughly flat as sales from the Switch and Scorpio launches help the category, but it is not known whether they will fully offset the expected decline in hardware sales resulting from recent trends and the decline in average hardware price points.

We estimate new software will decline mid-single digits, based on our current visibility into the title lineup. We expect preowned to perform similar to new software. We forecasted collectibles' revenues to increase 30% to 40% to approximately $650 million to $700 million next year as we continue to expand space in GameStop stores and as we open more collectibles stores and grow our thinkgeek.com business. The collectibles business should have about a 10% operating margin for 2017.

We also expect to drive gross margin higher by 50 to 75 basis points as we continue to grow tech brands and collectibles. SG&A will increase due to the growth in tech brands and the impact of the full year of the acquisitions completed in 2016. We expect tech brands' sales to increase 10% to 16%, while our gross margins are forecast to increase between 400 and 500 basis points, and operating earnings are expected to grow over 30% to $120 million. We will continue our efforts towards our 2019 goal of reducing costs in our videogame stores by $100 million. However, positive impacts from tech brands, collectibles and cost savings are not expected to offset the projected declines in physical video games, and as a result we expect operating earnings to decline between 3% and 10%.

Overall, we expect more than 40% of our operating earnings will come from sources other than physical games and we are on track to achieve our goal of 50% by the end of 2019. We are forecasting interest expense to be approximately $5 million more than in 2016, as we will have the debt outstanding all year. We are forecasting a tax rate of approximately 35% in 2017 compared to an effective rate of 30% in 2016. As I mentioned earlier, we benefited from tax strategies implemented in 2016, some of which will help to reduce our rate in 2017 to approximately 35%, with much of the benefit hitting the first quarter.

The increase in effective tax rate from 2016 to 2017 will have a negative impact of approximately $0.25 per share on 2017 EPS. As stated in our earnings release, we are guiding to full-year EPS of $3.10 to $3.40 per share for 2017, or down between 9% and 18% on assumed average shares outstanding of 102.5 million. We project free cash flow for 2017 to be approximately $300 million, with the largest variance from 2016 being the 53rd week and the timing of payments due February 1, 2018. We benefited in fiscal 2016 from our fiscal year ending on January 28.

You can expect the next couple of quarters to play out differently than recent years in that there are fewer AAA title launches in the first half. There are also several meaningful technology and hardware releases in Q3 and Q4, including the next iPhone, which will likely drive increased spending in the second half. Assuming that some portion of consumers will adopt a wait-for-it approach, and we have reflected that in our quarterly budgets, you can expect approximately 20% of our annual earnings to come in the first half compared to 25% in each of the last two years.

We expect to reduce capital expenditures approximately 20% from $142.7 million in 2016 to between $110 million and $120 million in 2017. We are planning to open approximately 35 new collectibles stores globally and approximately 65 technology brands stores. As we have done in the past several years, we expect to close approximately 2% to 3% of our store footprint.

Looking at capital allocation, our Board recently approved a 2.7% increase in our dividend payout, which continues to show confidence in our business transformation and will result in returning approximately $155 million to shareholders in 2017. The remainder of our excess cash can be used for additional M&A, most likely AT&T franchisees, or for share repurchases. Priority will be given to the investment opportunities that we believe will drive growth.

Last April at our Investor Day we gave you a long-term roadmap for operating earnings growth. I'd like to update that roadmap. We forecast that we can achieve $700 million of 2019 potential operating earnings. However, it will now take contributions from the Switch and Scorpio launches for us to achieve that goal. We are still forecasting tech brands and collectibles to be the principal drivers of the growth in our profits in the next three years.

I will now turn it over to Tony for his comments.

Tony Bartel - *GameStop Corp. - COO*

Thanks, Rob. Good afternoon. I would like to spend my time walking through results and expectations around our four strategic pillars. Let's start with the physical games segment. During the fourth quarter, in an environment of heavy discounting, particularly around the holidays, we chose not to sell hardware below cost. While we did give up some share in hardware, we actually increased our attach ratio of profitable new and preowned software. We ended the quarter with a software attach ratio that was double the rest of the industry.

We were able to accomplish this by leveraging our PowerUp Rewards program and specifically focusing on our PowerUp Rewards Pro customers. For the year, we grew our PowerUp Rewards Pro customer base thanks to a strong focus in our stores in the back half of the year. As a reminder, these PowerUp Rewards Pro customers spend six times the amount of a nonmember, and PowerUp Rewards members accounted for 71% of our GameStop-branded store sales in the fourth quarter.

Our preowned business continued to outpace new software declines, as Q4 was 12.6 points better and the full year was 9.1 points higher. I also believe we are seeing a resurgence in preowned technology, as phone customers on the Next program and other similar programs now own their phones and are bringing them back into our GameStop-branded stores to use as currency. We are rolling out new technology to streamline this trade-in experience in our stores.

Moving to 2017, we are cautiously optimistic about innovation in the category. We recently returned from Sony's Destination PlayStation, where we reviewed all major games in development, and we are impressed with the quality of the games that we saw. As Paul said, we are also pleased with the reason Switch launch, where we sold through our initial allocation in two days. We have had multiple replenishments since the launch, all of which have sold out in hours. In addition, we attached over 5 1/2 software and accessory items to each unit sold. Based on our quick sell-through and high attach rate, we expect to continue to receive an attractive share of this allocated product.

VR is also in strong demand. On average, we sell our limited allocation of product in less than a week. New titles like Resident Evil create spikes in demand, and we do believe that demand will continue to outstrip supply this year. Finally, we are impressed with Microsoft's Scorpio product and feel that we were over-indexed on this gamer-friendly, powerful console when it launches this holiday. So, to summarize physical video games, while we were disappointed in Q4, we as a Company continue to execute where there are opportunities to profitably enhance the business and offset the industry trend.

Moving to our digital business, our digital receipts grew 4% to $1.1 billion during the year. We are currently scheduled to launch two more GameTrust games, Has-Been Heroes and Deformers, in the next two weeks. Has-Been Heroes is launching on all platforms, including the Switch, where it is rated as a top five upcoming Switch game by Forbes Magazine. We are expanding our space for additional indie and PC games to increase share in these important categories. Also, we are increasing our linear space for in-game content such as Madden Ultimate Team, FIFA Ultimate Team and Grand Theft Auto Shark Cash. We expect to grow our digital receipts in the mid-single digits in 2017.

Our technology brands business had an impressive year, finishing with over $90 million of adjusted operating profit, growing 216%. Traffic comps were negative 0.9% for the fourth quarter and negative 1.3% for the year, as we managed through inventory outages of certain mobile devices in the back half of the year. Comp gross profit was down 9% in the quarter and down 4.8% during the year, as we are in the midst of pivoting this business to sell more DIRECTV and high-speed Internet. We are excited to be working with a partner like AT&T that has new and innovative products to sell and we are flexing our business to align with their new incentive structure. As we train our associates to take advantage of this transition, we expect gross margin comps to lag traffic comps by 5 to 10 points for the first two quarters. For full-year 2017, we expect traffic and gross profit comps to both be positive.

We have also added new B2B traffic-driving initiatives both in our stores and outside of our tech brands stores to focus on our key small business accounts that drive new transactions. We continue to remain one of the most productive authorized retailers in the AT&T system. Live to date we have made acquisitions of $750 million in this business and have generated a return that exceeds our 20% IRR hurdle. Our 2017 plan of over $120 million of operating profit that Rob articulated continues as above-hurdle performance. As Rob mentioned, we did trim our tech brands portfolio, primarily due to unprofitable stores that we acquired in acquisitions, conversions of RadioShack stores in low AT&T market share markets and Simply Mac stores that were negatively impacted by low product allocations from Apple.

Finally, collectibles had a strong year, ending near our $500 million stretch goal. We have made strategic investments in this category over the last two years, and those are beginning to pay off. In addition to consolidating our thinkgeek.com logistics into our Louisville warehouse and expanding our Dallas DC to accommodate additional collectibles product, we continue to increase the dedicated space in our stores. We are taking the following steps to grow this business in 2017. In the US, we are doubling the amount of dedicated wall space from 7.5% of linear feet to 15% of linear feet. We are converting 50 of our largest stores in the US to hybrid stores, where half of the store footprints are dedicated to collectibles.

We are converting over 100 of our international stores to hybrid stores. We will add 20 dedicated ThinkGeek stores in the US and 15 dedicated stores internationally. We are dedicating three- and six-foot store-within-a-store sections within our US GameStop-branded stores to feature unique licensed products from relevant movie and TV properties. We are entering into licensing agreements with major IP holders to produce unique product to support our $650 million to $700 million sales plan. We are leveraging our loyalty program in each country to drive relevant product around a robust launch schedule. And we are leveraging best practices from around the world. To put this into perspective, if we grew the US collectibles penetration to international levels, we would generate an additional $200 million of collectibles' sales annually.

In summary, we continue to execute on our strategy of diversifying our business towards our growth pillars while continuing to optimize our share in the cyclical gaming market. With that, I'll turn the call back over to Paul.

Paul Raines - *GameStop Corp. - CEO*

Thanks, Tony and Rob. With that, operator, we'll open it up for questions and answers.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) San Phan, Mizuho.

San Phan - *Mizuho Securities - Analyst*

Based on the rough math, I'm getting nonphysical gaming representing more than 50% of operating margins for this year. Does that jive with your numbers?

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

The comment that I made in my prepared remarks -- this is Rob, by the way -- was north of 40%.

San Phan - *Mizuho Securities - Analyst*

Okay. And then can you just maybe clarify what's embedded in your top-line guide with Nintendo Switch units?

Paul Raines - *GameStop Corp. - CEO*

There's a lot of excitement about the Switch, San, but there's also a lot of caution. Nintendo hasn't spoken a lot on it publicly. We saw the Wall Street Journal article. We are very cautious simply because of allocation. But do you want to comment anything on this, guys?

Tony Bartel - *GameStop Corp. - COO*

I would refer back to my remarks that, based on the high attach rate that we have and the quick sell-through, that we do anticipate having a higher -- the highest market share, but that's pretty well all that we can say at this point.

Paul Raines - *GameStop Corp. - CEO*

The way we see it, San, is that we really don't have an aggressive forecast built in here. And we have learned with Nintendo through the years not to do that. But there's models out there that you could look at that will give you a better idea of what could happen here.

San Phan - *Mizuho Securities - Analyst*

Okay, great. And then just a further question on the difference between the same-store sales numbers in the US and abroad -- was that mainly just the heavy discounting that you saw from your competitors in the US? Or was there something else that could explain the difference between the domestic and international markets?

Paul Raines - *GameStop Corp. - CEO*

The way we see it, San, is we're trying to drive best practices around the world. But clearly, the international markets had a better year of -- or less decline in growth. Mike Mauler is here. Do you want to talk about what you guys have done to drive best practices?

Mike Mauler - *GameStop Corp. - EVP, President of GameStop International*

Sure. I think, first, that every market is different. And there are some real foundational difference between the markets. PlayStation, for example, in Europe has 70% market share. It's much more even here. And so, when it came to PlayStations, VR launch and the launch of PlayStation Pro and some of the really good titles they had -- that moved the meter a lot more internationally than the US.

I think one of the other things is internationally we are about 90% mall-based. And so, there is a lot more casual consumers in the malls and in our customers in those stores. So when you have some major new releases, as Paul mentioned, like eight new releases in the fall that significantly missed our expectations, those would affect the stores where your mass-market consumer is just a lot greater percentage. And so I think when you put those things together, there will always be variability between the markets. But those are some of the big reasons.

Paul Raines - *GameStop Corp. - CEO*

And the other thing I would add, San, is it's clear to us that the international markets maybe are less further along with the console cycle and they are also less digital.

San Phan - *Mizuho Securities - Analyst*

Thank you.

Operator

Seth Sigman, Credit Suisse.

Seth Sigman - *Credit Suisse - Analyst*

I had a couple questions on tech brands to start. The gross profit comp improvement that you are going to for this year, flat to up 2%, sounds like it's going to be more back-end weighted, which makes sense. But are you guys assuming an improvement -- is there an assumption here for certain new products that haven't been announced yet? Any more color on what would be driving that improvement? And then the second piece of that is, in terms of the operating margin improvement that's embedded here, it looks like 100 to 200 basis points for tech brands in 2017. Any more color on that would be helpful also. Thank you.

Paul Raines - *GameStop Corp. - CEO*

Yes. Jason Ellis is here. Jason, so why don't you take the first part, and then Rob can follow up.

Jason Ellis - *GameStop Corp. - President of Tech Brands*

Hi Seth, thanks for the question. And I'll lead off with the margin comps. We anticipate that we are going to do a lot of -- we are going to have a lot of growth in our TV business this year. DIRECTTV is a new product that we have only sold in stores for a little over a year now, and we are anticipating we're going to be able to double that business. We also have some programs in place that are going to be outside of the four walls. We think small- to medium-size businesses are a segment that are underpenetrated today, and we have a unique position with the scale we've created with 1,500 stores to be able to get out and attack those small- to medium-sized businesses. So we have some unconventional ideas, I would say, on how we are going to drive more profit into those retail stores. And we're excited about those.

In terms of the margin, we also have a great opportunity for us to bring some additional accessory products and services and move upstream into the retail stores. And I would say specifically things that are in the connected home category that might connect to Apple's Home technology on the smartphones that we are selling or Samsung's SmartThings. Those are both really good opportunities that we haven't brought into the stores yet today.

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

In terms of the operating margins, Seth, with the growth in the store count that we had last year through the acquisitions, we have the opportunity to really leverage the infrastructure that's in place around the business. And that will help as well.

Seth Sigman - *Credit Suisse - Analyst*

Rob, are there any parameters you can give us around the scalability of the model in terms of the type of comps you need, now that you do have that infrastructure in place? Anyway to think about that?

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

I think we have to get back to you on that one. I don't really have that information off the top of my head.

Seth Sigman - *Credit Suisse - Analyst*

Okay, great. Thanks very much.

Operator

Colin Sebastian, Robert Baird.

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

I have a couple of questions. First off, probably for Rob, just a clarification on the EPS guidance. With the midpoint roughly $0.50 below what you reported for 2016, you mentioned $0.25 from the tax rate. Can you break out the other $0.25 or so? Is that related to below-the-line items or is there something else in there?

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

Approximately $0.03 that would be related to the interest expense that I talked about being $5 million higher year-over-year. The remainder would come from the operating earnings which I mentioned would -- we expect to decline between 3% and 10%.

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

Okay. So there was no restructuring or store closing costs that are somehow embedded in that number?

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

No.

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

Okay. Secondly, in terms of capital allocation and the free cash flow guidance versus 2016, how should we expect that to impact dividend payments and share repurchases, if at all?

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

Well, we talked about the dividend payments, and we raised the dividend 2.7%. It's now $1.52. And we would expect that that would have about $155 million payout, given the share count. In terms of further use of free cash flow, we talked about the priorities being to drive growth initially and then, to the extent available, free cash -- excuse me, buyback.

Paul Raines - *GameStop Corp. - CEO*

Let me provide some color on that, Colin. It's no secret that we've been a strong buyer of our stock. We've bought over $2 billion, and I think we've done the right thing on that, and we've demonstrated a willingness to return cash to shareholders. Our dividend speaks for itself; it's a very healthy dividend. It's a good holding. As we face into the future, there's a lot of uncertainties, as you just saw, in holiday for us. The physical gaming category is in a -- what we think is a cyclical decline before a new set of technologies. We need to see Switch, we need to see PlayStation VR, and we need to see E3 before I think we can make any guidance or forecast. It is logical to assume we would return all cash flow over and above investments, but we're not ready to make the statements until we see what has been an uncertain category play out.

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

All right. Then maybe, Paul, on that note, lastly on Switch. What in particular signals to you guys that this has Wii-like potential, in terms of broadening the market beyond the traditional Nintendo fans?

Paul Raines - *GameStop Corp. - CEO*

I'll let Tony answer that question. But just one comment for all of you guys -- I hope you've played it. If you've played it, that's the best way to know that it has tremendous broadening potential. Tony, what would you say about our sales and --?

Tony Bartel - *GameStop Corp. - COO*

I would say two things. First, just the demand is incredibly strong for this, Colin. And as soon as we get it into our stores, it's out within hours. And so we are going to be -- we anticipate that we are going to be chasing supply this entire year. The other thing is that every game that's out there, to have over a 5 1/2 attach rate to this signifies that a lot of people are finding this a great platform and they are picking up any game that they can. We have almost a one-to-one attach with Zelda, which is a great game. But there's tremendous demand for this, and we just don't know how high it is because every time we get it out in our stores, it's literally gone.

Mike Mauler - *GameStop Corp. - EVP, President of GameStop International*

I would also add that Nintendo has got several more great games they're launching this year for the console, which we didn't see with the Wii U. Mario Kart 8 will be in April and there's a couple more that I don't think have been announced yet, as well as there's some good third-party publishing support on the Switch, which we really didn't see with the Wii U either, and that will drive demand.

Paul Raines - *GameStop Corp. - CEO*

So the way we see it is all the data says it selling. There's tremendous demand. Everything we do, it seems, sells out quickly. But if you play the device, it's far more focused on motion and on the controllers than it is -- the Wii U was very focused on the tablet, and a lot of the gameplay revolved around touching the tablet and all that sort of thing. This one feels a lot more broad -- a lot more movement associated, and we think that's going to be a broader appeal. We'll see. We'll see what they announced on numbers.

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

Thank you.

Operator

Brian Nagel, Oppenheimer.

Brian Nagel - *Oppenheimer & Co. - Analyst*

The first question I wanted to ask, just with respect to the fourth-quarter charge and store closings in the tech brands division, as you look at the AT&T stores you are closing, was that something that was anticipated as you made these big acquisitions and you reviewed those portfolios? Or was it a decision that came later, after you looked closer at the performance of these units?

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

In terms of the stores that came with the acquisitions, we acquired larger businesses last year. And they had a portfolio of stores, some of which were performing extremely well and some of which were not performing. And unfortunately, we couldn't cherry pick what we bought. We knew that we would have to deal with some number of these stores. And so you see part of that -- you see that in part of these numbers.

In terms of the RadioShack locations, we took a pretty aggressive approach, working with AT&T to find locations to help them try to replace the traffic that they were getting out of the RadioShack store base overall. We took about 120 locations, some of which were in markets where AT&T didn't have strong share, as Tony talked about. And unfortunately there was a number of these stores we just couldn't make work. Now, those are the bulk.

Paul Raines - *GameStop Corp. - CEO*

Yes, I mean -- I think, Tony, you may want to share. If you go back in history, the way we see it is AT&T, our partner, needed to recover lost sales at RadioShack.

Tony Bartel - *GameStop Corp. - COO*

Sure. We had worked very closely with them as we looked at the RadioShack stores and we knew when we went in we were taking some risks, but we got some great real estate. The whole portfolio has worked out well, but there were some stores that we knew were in low market share. But we, as good partners do, we worked together with them to try and retain as much of the traffic that they were losing from the RadioShack stores.

Paul Raines - *GameStop Corp. - CEO*

And we have achieved our 20% IRR hurdle, so we feel like it was good culling of what we had. Now, there's another side of this, which is, of course, the Simply Mac side. I don't know if you want to talk about that or not, Colin, but that's a --

(multiple speakers) That would be Brian. That's a very different animal.

Brian Nagel - *Oppenheimer & Co. - Analyst*

(multiple speakers) Do the closures in that division reflect some type of strategy change for Simply Mac?

Paul Raines - *GameStop Corp. - CEO*

Yes, that's a good question. And I'm going to let Jason maybe take that. But just remember, we have a $1 billion relationship with Apple, so Simply Mac doesn't define our Apple relationship. We are heavily into the Apple business. But Jason, do you want to talk about Simply Mac?

Jason Ellis - *GameStop Corp. - President of Tech Brands*

Yes, I do. When we talk about Simply Mac, I'll reiterate what Paul said. We have a multifaceted relationship with Apple. So, in our retail business or on our mobility business, we sell over 1 million iPhones for them. We sell a lot of product. And so we are a great channel partner for them. On the Simply Mac side, that channel distribution strategy has been a little more difficult, largely due to product allocation.

I think Apple would admit that when they got into the second half of last year, a lot of the products that they launched were heavier allocated then they've seen in years prior. But we saw that the stores that we've had for a long time that have an embedded base still performed very well. Our service business continues to grow. So it was really, again, a culling of some of the real estate that we just didn't think had long-term potential.

Paul Raines - *GameStop Corp. - CEO*

And so, Brian, we feel pretty good about the technology brands strategy. I don't think there's a strategy shift. We did think we would grow Simply Mac faster and Spring Mobile slower. That was the original thinking. I think today we would say we are growing Spring much faster, and so we don't mind reducing the size of our Simply Mac. But Simply Mac is a good business, it goes forward. We just had a great meeting with Apple yesterday, by the way, so we got lots of exciting things we are planning on doing with them.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Great, thanks. So just as a follow-up to that then, Paul, on the AT&T business, you made the big acquisitions last year. How should we think about the unit growth in that division into 2017 and going forward now?

Paul Raines - *GameStop Corp. - CEO*

Well, I would say -- and maybe I will that Rob or Jason talk about the unit growth -- but we are very strong with AT&T in lots of different ways. We were at the Pebble Beach sales meeting they had. I'm calling it a sales meeting because I don't want to call it a golf extravaganza. But we are very tied at the hip with them. They have a lot of things going on. And so we think there's an opportunity to grow stores but also other forms of revenue driving. You want to talk about the unit growth guidance, Rob?

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

Yes. We talked about 65 what we call white-space stores on the technology brands side. And so you can frame it that way. We will continue to look for AT&T reseller acquisition opportunities. We've been very successful with that. We don't expect anything of the size that we did last year, obviously. There aren't that many dealers of that size available, but we do think there are still a large number of opportunities to consolidate smaller resellers.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Thank you.

Operator

Curtis Nagle, Bank of America Merrill Lynch.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

So just a quick one on the Scorpio. So I'm just kind of curious why you guys -- or what gives you optimism on a launch, just given how the Pro or the PS4 has performed, upgrades that theoretically aren't all that different, and what doesn't look like a particularly strong slate of exclusive titles for the Xbox system over the next year or so.

Paul Raines - *GameStop Corp. - CEO*

Yes, thank you for that, Curtis. Let me start it off and I'll ask Tony to follow up. The way we see this is we see Switch as being very strong. That indicates there's a demand out there for gaming. We were just at a studio this week, a group of us, and we heard a lot of excitement about Sony VR. And so you can't discount VR from this discussion because what Sony VR will do is it will put pressure on Microsoft. So we have a pretty interesting expectation now about Sony VR that maybe we didn't have. When you talk to studios it helps you get a little more insight into what's going on. But Tony, you want to talk about what we know about Scorpio and what we can't talk about?

Tony Bartel - *GameStop Corp. - COO*

Unfortunately, we can't talk about a lot other than what's known out there. What is public is it is a very powerful system that's really made for 4K. And we see it as a very gaming-centric, very, very powerful unit. And so, we do believe that there will be significant -- some great games that are made for this. And we do believe that GameStop is poised to significantly over-share in this launch when it happens.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Okay, and then (multiple speakers) -- sorry, go ahead, Paul. My apologies.

Paul Raines - *GameStop Corp. - CEO*

I was just going to say that you have to believe that if VR becomes a meaningful part of this business, which we don't know if it will, but the likelihood is and the indications are that everything we get that's Sony VR sells out -- you have to believe that others will want to get in that game. So that's one of the reasons we are bullish.

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Got it. And then just a quick follow-up on free cash flow guidance for this year. It looks like, I think about $300 million, so a step down of about $100 million despite lower CapEx. Just curious what's driving that.

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

Well, as I mentioned in my remarks, the timing of the year end -- this year, January 28; next year, February 3 I think it is -- means that any of those bills that were due February 1 -- whether they are rent, international payroll, certain vendor obligations -- would fall into the fiscal 2017 timing, and they didn't fall into the fiscal 2016 timing. So we got a benefit in 2016 that flips around on us a bit in 2017. Obviously, as we approach the end of the year, as we work our way through the year, we are going to manage our payables and our inventory levels and working capital in the most efficient manner possible, but there just will be an (technical difficulty).

Curtis Nagle - *BofA Merrill Lynch - Analyst*

Okay. Thank you very much.

Paul Raines - *GameStop Corp. - CEO*

Okay. With that, I guess we will wrap up the call. Thank you very much for your support. Please stay tuned. We've got a lot of exciting things going on at GameStop and look forward to speaking with you in the next quarter.

Operator

Once again, that does conclude today's call. We appreciate your participation.