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LF - Q3 2012 LeapFrog Enterprises, Inc. Earnings Conference Call

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OVERVIEW:

LF reported 3Q12 worldwide sales of \$193m and net income of \$42m or 0.60 per diluted share. Expects full-year 2012 net sales to be \$535-550m and diluted EPS to be 0.75-0.81.



CORPORATE PARTICIPANTS

Karen Sansot LeapFrog Enterprises - Senior Director of IR

John Barbour LeapFrog Enterprises - CEO

Ray Arthur LeapFrog Enterprises - CFO

CONFERENCE CALL PARTICIPANTS

Scott Hamann KeyBanc Capital Market - Analyst

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John Taylor Arcadia Investment Corporation - Analyst

Drew Crum Stifel Nicolaus - Analyst

PRESENTATION

Operator

Good evening. My name is Mya, and I will be your conference operator today. At this time I would like to welcome everyone to the LeapFrog Q3 2012 earnings conference call. (Operator Instructions). Ms. Sansot, you may begin your conference.

Karen Sansot - LeapFrog Enterprises - Senior Director of IR

Thank you. Good afternoon, and welcome to the LeapFrog Enterprises conference call to review our results for the third quarter ended September 30, 2012. I am Karen Sansot, Senior Director of Investor Relations. Today on the call we have John Barbour, our Chief Executive Officer; and Ray Arthur, our Chief Financial Officer.

Before we begin, I have a couple of housekeeping items to go over. Mark your calendars we will be hosting our annual investor event in New York the morning of Tuesday, February 12th. We will send out details in a few weeks. This event will also be webcast on our Investor Relations website at www.leapfroginvestor.com. Please refer to this website for current information about LeapFrog.

And now for the Safe Harbor statement. We wish to remind you that our statements today will include forward-looking statements about management's expectations, including expectations regarding anticipated 2012 financial results, such as anticipated sales and earnings per share. In addition, we expect the questions posed in the Q&A portion of this call to prompt answers that contain additional forward-looking statements not included in our prepared remarks.

You should be aware that actual results might differ materially from those projected in any forward-looking statements. Some important factors that could cause actual results to differ materially from those in the forward-looking statements are described in our most recent Form 10-K filed with the SEC. LeapFrog makes these statements as of today, November 5, 2012, and disclaims any duty to update them. I would now like to turn the call over to John Barbour.



John Barbour - LeapFrog Enterprises - CEO

Good afternoon. As the CEO and a shareholder of LeapFrog I am very pleased with the quality of execution from the LeapFrog team as we transform our business and deliver another quarter of strong market leading performance. We are on a journey to transform LeapFrog from an educational toy company to the leading developer and distributor of educational entertainment. This year we have made great strides in this journey.

We successfully launched LeapPad2 the next generation of the number one kid learning tablet, the LeapsterGS a revolution new version of our award winning and top selling learning game system, and we will more than quadruple a Explorer content library from approximately 100 titles to more than 400 of the best educational entertainment titles by the end of year. We continue to develop partnerships with leading children's entertainment companies to distribute their content across our platforms. We have now entered into distribution agreements with 26 different companies including Disney, Sesame Workshop, PBS, Nickelodeon, Discovery Education, HIT Entertainment, Mattel, Hasbro among many more.

Another key element of our transformation is our growing investment and expansion of our character IP through the internal creation of more great LeapFrog titles across a variety of entertainment media. A good example of this is the announcement this morning of our agreement with Lionsgate, who will distribute four new LeapFrog Letter Factory movie DVDs that we will create and produce internally. Our ability to create great animated movies may not be well known, but our original Letter Factory DVD has more five star ratings on Amazon than the three top grossing kids movies of all time with 991 five star reviews. LeapFrog's valuable home entertainment catalog has sold nearly 9 million units to date, and continues to lead the industry for educational programming. I nearly forgot to mention we have retained the distribution rights for these new movies across our own proprietary platforms.

Another I topic I would like to touch upon before I discuss our year-to-date results is the competitive landscape in the tablet market. We all knew the tablet market was going to be hot this holiday season, and at the end of the second quarter we knew there was going to be a number of new tablets hitting the market before the end of year. But we had limited intel on how competitive they were going to be versus our new LeapPad2. Today we have a lot more clarity in the competitive landscape. I and many of the LeapFrog team members have spent hundreds of hours playing with and experiencing our competition. The bulk of these competitor tablets have been designed for adults not children, and we believe most are quite unsuitable for unsupervised play by a child of three to eight years old. The LeapPad2 was specifically designed for children. We only make products for children.

Over the last 17 years we have successfully launched more revolutionary products that deliver intensely fun learning experiences for children than any other company in the tablet space. Every element of the LeapPad2 has been created with a child in mind, right down to its kid tough design. And as we all know, hardware is only a small part of the equation when you buy a tablet for a child. It is the content that the child experiences on the tablet that keeps them entertained and helps them learn. The LeapPad2 is supported by a content library of hundreds of cartridges, videos, games, eBooks, and apps all of which have been co-developed or selected by our in-house team of highly experienced child development and education experts. We have created a hardware content combination that I firmly believe is the best in the market for children. A tablet designed specifically for kids, and a safe place for parents to find all that is best in fun, compelling and engaging content that delivers life-changing learning and helps children achieve their potential.

Those of you that are still concerned over the competitive impact of LeapPad2 I suggest you look at a few more other important market elements. One, if you go to most retail stores that sell these products you will see most of the tablets are merchandised in the electronic section and a lot of times they are behind glass. On the other hand, the LeapPads are featured in the kids and toy sections, easy for most consumers to find. Two, the LeapPad2 continues to win far more independent awards and gets dramatically better online consumer reviews for a children's tablet than the competition. And, three, the LeapPad2 has been selected as a top toy for holiday 2012 by far more retailers and kid experts than any other tablet. Perhaps that is why major retailers are telling the world that the LeapPad2 is already one of their best selling layaway products of 2012.

So let us look at our year-to-date 2012 performance. As a result of our Company's transformation and improved business execution we delivered exceptional financial growth and built cash while continuing to invest in the future of our Company. Year-to-date we have increased net sales by more that \$91 million up 37% compared to a year ago. We are gaining share and growing in all of our key markets. Year-to-date U.S. net sales are up 36% and International net sales have grown 41%.



Our gross margins to date have expanded by 250 basis points year-on-year, driven largely by volume and a higher mix of content sales. Our operating profit to date is nearly as much as we earned in all of 2011 and is up \$31 million from a year ago. On a per share basis we increased EPS by \$0.55, and have already reported more earnings per share to date in 2012 than all of 2011, and we are building cash. Our cash balance has nearly double compared to a year ago.

Our terrific financial performance has been driven by high consumer demand for a leading educational entertainment portfolio, which is experiencing strong double-digit POS growth in the U.S. and many International markets. As a leader in children educational entertainment we benefit from the universal desire by parents to help their children get the best start in life and by the growing global need for supplemental education. As schools face budget cuts it is more important than ever to provide children with the tools that extend learning beyond the classroom. Research shows that achievement in kindergarten directly relates to later academic success; however, almost half of students are not fully prepared when they enter kindergarten. To be successful in the 21st century children need a broad set of skills ranging from reading, writing, math, problem solving, social skills, science, to music and much more. LeapFrog is unique in that we offer fun and engaging education entertainment learning solutions for children that cover a wide range of subjects and skills and are carefully created and selected by an in-house team of education experts. Our learning content is grounded in the latest research and draws on comprehensive curriculum that covers more than 2,500 skills across 100 skill categories. We help parents prepare their children for life success.

At LeapFrog we believe that play is an essential part of learning, and if you make learning fun, it will be dramatically more effective. We know how children like to play and how they learn, and we sweat the details with each and every one of our products. As a result we have the number one kid learning tablet with LeapPad, the number one kid learning game systems with Leapster, and the number one Learn to Read system with Tag and a strong line of preschool learning toys and valuable home entertainment catalog of educational videos and DVDs. Reviews of our products are exceptionally high, and I believe no other company has won more parenting and education awards than LeapFrog. Children love our products and parents love the impact our products have on children. Millions of parents love and trust the LeapFrog brand. They know that we provide the best and the most engaging and the most nutritional entertainment on the market.

With our leading product portfolio terrific year-to-date results and parents increasingly looking for learning solutions for their children we head into the holidays with good momentum. We are entering the fourth quarter this year in much better position than we did last year. Exceptional execution from our supply chain team has resulted in us having far better inventory of LeapPad in our pipeline, and we have a lot more inventory already on retail shelves.

At the same time the major children product markets - toys and video games, are experiencing significant declines and we are facing an uncertain economy in an election year, and the impact of major retailers very successful layaway programs pulling forward consumer demand in to quarter three from quarter four is unknown. We continue to be energized by the opportunity ahead of us. Last quarter we made great strides in our transformation, delivered market leading financial performance and added three world class leaders to our senior management team. But just as important, we are really excited about the positive impact our products are having on millions of children around the world. I would now like to turn it over to Ray to discuss our financial performance.

Ray Arthur - LeapFrog Enterprises - CFO

Thank you, John, and good afternoon. In the third quarter we delivered solid sales growth which combined with continued expense control, drove significant improvements in both operating and net income. With three quarters of the calendar year behind us, we are pleased with our results and believe we are well positioned heading into the all important holiday season. This belief is based on our strong product portfolio including our extensive educational entertainment content library, our newest educational children's tablet LeapPad2 and continued POS growth and higher retail inventory levels versus the same period last year. In addition, our holiday advertising campaigns, retail promotions, and message at shelf have all been significantly improved. While we are cautious about the economy and as you know there is still more that 50% POS sell through that happens between now and the end of year, we have built momentum to carry us into the holiday season.

Now let me provide a bit more insight into our third quarter financial performance as summarized in the financial tables accompanying the press release. Worldwide sales for the quarter were \$193 million up 28%, compared to \$151 million a year ago and were negatively impacted by 1% due to changes in currency exchange rates. The worldwide growth was largely driven by the introduction of new products including LeapPad2 as well



as LeapsterGS and our Touch Magic toy line. Consumer demand for both LeapPad hardware platform and content continues to be high. In addition we do believe that some of our growth was driven by our building a better inventory position this year and a potential shift of the some sales from the fourth quarter to the third quarter.

Net sales for our U.S. segment were \$146 million up 26%, compared to a year ago. POS for our U.S. segment remained robust in the quarter. Strong sales of LeapPad, LeapPad2 and content drove the year-over-year improvement. In our International segment net sales were \$47 million up 36%, compared to a year ago and were negatively impacted by 3 percentage points from changes in currency exchange rates. Momentum in our International segment remained very strong in the quarter with robust selling growth and strong double-digit POS growth in all key markets.

Turning to line of business. Worldwide net sales of multimedia learning platforms and content were up 48% year-over-year driven by LeapPad platforms and sales of LeapPad2 hardware in the quarter more than double that of LeapPad1 in Q3 of the prior year. LeapPad cartridges and accessory sales were particularly strong, also more than doubling. Within our gaming business sales of our new GS gaming system are meeting our expectations, but were more than offset by declines in gaming platforms which are nearing the end of their life cycle. Within multimedia learning platforms and content our traditional reading business which includes Tag and Tag Junior hardware and the related physical books was down year-over-year given the planned transition to our new reading solution plan-o-gram and new book packaging which began late in the quarter. However, our Holistic Reading business, which in addition to the Tag and Tag Junior platform also includes eBooks for our gaming and tablet platforms was, flat compared to the prior year.

Moving on to learning toys. According to NPD's most recent year-to-date toy industry report through September, toy industry sales are down about 6% in the U.S. Our learning toys sales are consistent with this trend with the overall decline partially offset by the launch of our new Touch Magic line in the quarter. Gross profit for the quarter was \$77 million an increase of 25% compared to the prior year. Gross margin was 40% for the quarter down 100 basis points year-over-year primarily driven by higher inventory allowances as a percentage of net sales due to product transition partially offset by proportionally lower trade allowances and discounts and higher sales volume which reduced the impact of fixed logistic costs. Impact from increased sales of lower margin mobile learning platforms was generally offset by increase sales of higher margin content and accessories.

Operating expenses for the quarter were \$40 million, up 10%, compared to \$37 million a year ago though down more than 300 basis points as percentage of net sales. SG&A and R&D both increased due to higher employee related expenses while advertising spend was slightly lower than the same period last year. As the result of significant sales growth and operating leverage, offset by slight gross margin contraction, we once again drove significant bottom line improvement.

Net income was \$42 million, an improvement of almost \$19 million year-over-year, and net income per diluted share was \$0.60 an improvement of \$0.25 compared to the \$0.35 net income per diluted share a year ago. Net income included a non-recurring tax benefit of \$6.4 million in the current quarter and \$2.9 million in the third quarter of 2011. Excluding the impact of non-recurring tax benefits net income per share would have increased by \$0.20 per share.

Let us move on to the balance sheet. Cash and cash equivalents finished at \$49 million almost double the \$26 million a year ago, and as a result of stronger cash position we do not anticipate drawing down on our ABL this year as we have in past years. Our accounts receivable balance was \$170 million an increase of 25% which trailed our 28% net sales increase. Our portfolio remains healthy, and our DSO decreased by over two days compared to a year ago period due to improved collections. Our inventory balance was \$115 million up \$45 million or 64%, compared to a year ago due to improved timing and phasing of LeapPad production intended to deliver product to retailers earlier and at higher levels to address higher anticipated POS in 2012. Operating cash flow declined by \$45 million in the quarter largely as result of significantly higher inventory balances as we better prepare this year for the upcoming holiday season and higher account receivables as the result of the third quarter sales performance. In summary our balance sheet is in excellent shape heading into this holiday season.

Now I would like to finish my prepared remarks with insight into our full year outlook. We remain committed to the financial goals we established at the beginning of the year which were to drive significant earnings growth through increased net sales and tight expense control while investing in future growth. While we are entering the holiday season with good POS momentum and strong retail and marketing plans we remain cautious as the retail environment is competitive and the economy unsettled. The next couple of months at retail are critical and will largely determine our full year profitability.



Regarding guidance, given the strength of our third quarter results, retail point of sale trends, and inventory position we are raising our full year 2012 guidance. Our guidance is based on our best view as of today, but keep in mind our full year 2012 will be highly dependent on the economy and consumer sales during the all important holiday season. In addition, please note we expect our advertising expenditures to increase by approximately 20% to 25% in the fourth quarter compared to a year ago as we concentrate our advertising spend during the key holiday weeks when consumer are shopping for gifts.

Specific to forward-looking guidance we now expect full year 2012 net sales to be in the range of \$535 million to \$550 million up \$80 million and \$95 million or 18% and 21% compared to 2011 and net income per diluted share to be in the range of \$0.75 to \$0.81 compared to \$0.30 in 2011. As we look to the future we are well positioned to grow our earnings and deliver strong cash flow. We have good product momentum, the leading children's educational tablet and exciting new product launches. We are transforming to being the leading developer and distributor of educational entertainment.

That concludes our prepared remarks and we would now like to open up the call for questions. Operator, who would you like to ask the first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question is from Scott Hamann from KeyBanc Capital.

Scott Hamann - KeyBanc Capital Market - Analyst

Good afternoon, everyone. Just in terms of some of the shelf space allocation you have going into the holiday season of potentially expanded distribution relationships with any retailers. Can you speak to where you are year-over-year?

John Barbour - LeapFrog Enterprises - CEO

I think if you go in to Walmart, Toys "R" Us, Target you will see we have expanded our space in stores an you will also see over the holiday season we are going to expand our promotions with them as well. We feel our team has made good progress in that area.

Scott Hamann - KeyBanc Capital Market - Analyst

Okay. In terms of the inventory levels in the channel, can you be a little more specific as to where you sit there versus trying to reconcile the inventory on the balance sheet and how you see this playing out?

John Barbour - LeapFrog Enterprises - CEO

One of things you will see through our Q3 numbers is that we shipped significantly more inventory into the market place to prepare for the holiday season. We came under some criticism last year for inventory levels on LeapPad, et cetera, so some of the volume in Q3 is certainly volume that we would have got in Q4 last year. You can see it in stores. Anybody who goes into store and talks to people in stores will see there is better inventory of our products in there, and um and fortunately we have more inventory at the moment in our pipeline getting prepared for the holiday season.

Ray Arthur - LeapFrog Enterprises - CFO

And we are seeing POS performing very well as a relation to that in stock position.



Scott Hamann - KeyBanc Capital Market - Analyst

Okay. Finally in the gross margin, you indicated there were some debt allowances that were recorded this quarter. Was that something that you had anticipated earlier? Gross margin was a little less than I had anticipated, and then for fourth quarter how does that look? Is there any guidance you can give us on where that should shake out for the year based on where you see it now?

Ray Arthur - LeapFrog Enterprises - CFO

Ultimately we do expect some improvement in gross margin rate year-on-year in Q4, but it is really all dependent on what the product mix comes out to be. The more content that is sold in relation to hardware will push that margin percentage up. If more hardware is sold than content sales spill into next year, there will be a little pressure down, but we do expect it to be somewhat better. As to the allowances that we recorded in the quarter, it is normal course of business in bringing some products to their end of life.

John Barbour - LeapFrog Enterprises - CEO

As far as transition we made it clear to people this was going to be a year or two out, and that we were going to execute in store and we were going to launch the new packaging on Tag, and that is all rolled up into what we have dealt with.

Scott Hamann - KeyBanc Capital Market - Analyst

Okay. Thanks a lot.

Operator

Your next question is from Mike Swartz from SunTrust.

Michael Swartz - SunTrust Robinson Humphrey - Analyst

Hi, good evening, everyone.

John Barbour - LeapFrog Enterprises - CEO

Hi, Mike.

Michael Swartz - SunTrust Robinson Humphrey - Analyst

With marketing spend came in obviously lower year-over-year and below most people's expectations. Was there anything during the quarter that caused you to push more of that out in the fourth quarter, lay away anything else, or was that always your plan for fourth quarter?

John Barbour - LeapFrog Enterprises - CEO

One of those things we really manage and sweat the details everyday of how we are investing our money, and we look at what activity we get in terms of the PR that we have out there. There is a certain amount of money we are going to invest in the business, and fortunately we have had incredible PR across our business and great support from our retailers for layaway, so it is just a wise move to move some of that advertising into the fourth quarter and get prepared. It is keeping up our drive for the time when the fish are swimming.



Michael Swartz - SunTrust Robinson Humphrey - Analyst

To build on that answer, how flexible are your plans with ad spending in the fourth quarter? If you continue to see the double-digit POS going through the heart of the holiday season, would you have to spend all of it, would you pull back, would you maybe invest in other platforms like you did last year?

John Barbour - LeapFrog Enterprises - CEO

We can move. It is not super flexible, but there is definitely some flexibility where we can move campaigns around, and we read it as I said literally every week we are modifying it and making tweeks to the campaigns and we tend to put advertising to the products that need the extra help to drive them off the shelves.

As you go into the fourth quarter the way the business rolls and the promotions literally things are changing quite a bit by the minute.

Michael Swartz - SunTrust Robinson Humphrey - Analyst

Great, thanks for the color.

Operator

Your next question is from Sean McGowan of Needham & Company.

John Barbour - LeapFrog Enterprises - CEO

Hi, Sean.

Sean McGowan - Needham & Company - Analyst

Hi, guys. How are you?

Ray Arthur - LeapFrog Enterprises - CFO

Great.

Sean McGowan - Needham & Company - Analyst

I am sure you are anticipating this question, so I will get right to it. You have inventory in place for a pretty good fourth quarter, you have advertising plan to drive a pretty good fourth quarter, and yet the low end of your guidance implies a decrease in sales for the fourth quarter, so how are we supposed to think about that?

John Barbour - LeapFrog Enterprises - CEO

A big part of it, you have to look at the standpoint of what is happening in the economy, you have to look at the stand point of us shipping more inventory into the trade through the first three quarters of which it is sitting there right now in preparation for the holiday season. All right. And



you have to look at the fact that we believe that some level of demand has been pulled forward for these super successful layaway programs. So when you do all the math and you look at our guidance I think you can see where there is some growth there.

Ray Arthur - LeapFrog Enterprises - CFO

And, Sean, still well over 50% of our POS at retail has yet to occur at this point. So having a fairly reserved look at what is going to happen in Q4 is in our mind still appropriate.

Sean McGowan - Needham & Company - Analyst

All right. Couple of other numbers that jump out here. Bad debt reserve what is behind that? Are you anticipating something, or is that just socking it away? And the tax benefit in the quarter, why so high, and what does that mean for fourth quarter next year?

Ray Arthur - LeapFrog Enterprises - CFO

Two things the allowance for doubtful accounts is up due to a discreet issue that happened to us earlier in the year when one of our distributor went out of business it cost us about \$3 million.

Sean McGowan - Needham & Company - Analyst

Okay.

Ray Arthur - LeapFrog Enterprises - CFO

As to the tax benefits, those tax benefits have all been realized -- those were FIN 48 reserves related to some previous operations that we had where the statute of limitations has expired. As of this point in time there are no further tax benefits in that regard. That being said, as I am sure you know we have significant NOLs that have been reported over the year that we do have a full valuation allowance on it at this point, and as we move forward with continuing profitability we will have to reevaluate that situation and see whether a reduction in that valuation reserve is appropriate.

Sean McGowan - Needham & Company - Analyst

Right. So I think what you have been saying in the past is we should expect nominal tax expense in the quarter (Inaudible) and here we have this big benefit. What should we be looking for going forward at this point?

Ray Arthur - LeapFrog Enterprises - CFO

I think what you should be looking for going forward is a fairly low tax expense. Like I said, we do have those net operating losses that will offset U.S. taxes. I would exclude the big benefits you are seeing perspectively with the one caveat that when we do look at the total valuation allowance we have against net operating losses at some point we are going to take that back if we continue to produce the kind of results we are seeing today.

Sean McGowan - Needham & Company - Analyst

And that would look like a big onetime gain and then followed by a normal tax rate?



Ray Arthur - LeapFrog Enterprises - CFO

It is done two ways. The accounting firms I believe have different views on it. Some are proponents of taking the full valuation allowance back at onetime, others will allow some partial recognition depending on facts and circumstances, and we have yet to get the point to concluded where we are headed there.

Sean McGowan - Needham & Company - Analyst

Quality problem. Thank you.

Ray Arthur - LeapFrog Enterprises - CFO

Sure.

Operator

Your next question is from Lee Giordano of Imperial Capital.

John Barbour - LeapFrog Enterprises - CEO

Hi, Lee.

Lee Giordano - Imperial Capital - Analyst

Hi, good afternoon.

John Barbour - LeapFrog Enterprises - CEO

Good afternoon.

Lee Giordano - Imperial Capital - Analyst

Could you talk a little bit more about your ability to chase demand during the holiday season. It seems like you are in a much better inventory position for the LeapPad, but let us just say the POS sales are better than you expected, what is your ability to chase demand into the channel this season?

John Barbour - LeapFrog Enterprises - CEO

Well, if you look at last year, most of you know, we actually air freighted a whole bunch of products in the quarter that helped us meet a whole bunch of demand in Q4 last year unfortunately robbed us of hardware sales in Q1, but we were prepared to do that because of the ongoing opportunities of selling accessories and selling content to those customers. So that is always a strategy that we could use again this year if we needed to. And we have a stronger manufacturing I believe. Our supply chain team have done a wonderful job this year of really improving our supply chain going forward. You know as well as I do in manufacturing time lines and just how complicated this product is there is always limits of that flexibility.



Lee Giordano - Imperial Capital - Analyst

Great. Secondly, can you talk some more about the Lionsgate agreement you announced and how the economics of that DVD business works?

John Barbour - LeapFrog Enterprises - CEO

It is one of the areas I am especially excited about. If you go and look at the original Letter Factory DVD most people do not know this, but as I said in my prepared remarks it has more five star rating than the top three highest grossing kids movies of all time. It is incredible. Our team have an amazing ability to create really life-changing education entertainment, and as we diversify our business and we become more of a broad based educational entertainment company then of course animation and other elements of delivering entertainment to kids with education are going to be important.

We have been working with Lionsgate now for a number of years. We have produced some really, I think exciting product with them. We are super excited about this new deal with them, because this time we are actually taking the development in-house, and managing all that in-house and involving our educational experts more in the process. And within that Lionsgate has the rights to go and distribute that product as they have done in the past, except for on our platforms we have the rights to distribute it ourselves.

Lee Giordano - Imperial Capital - Analyst

Great. Thank you.

Operator

Your next question is from Gerrick Johnson of BMO Capital Markets.

Gerrick Johnson - BMO Capital Markets - Analyst

Good evening. I was hoping you could go over some numbers again. The gaming and toy numbers for the third quarter, how much were they up or down?

Ray Arthur - LeapFrog Enterprises - CFO

The multimedia platforms?

Gerrick Johnson - BMO Capital Markets - Analyst

Yes.

Ray Arthur - LeapFrog Enterprises - CFO

Content and platforms were up 48% year-over-year. That was driven by LeapPad platforms and sale of LeapPad2 hardware in the quarter.

Gerrick Johnson - BMO Capital Markets - Analyst

And toys.



Ray Arthur - LeapFrog Enterprises - CFO

Toys, they kind of followed the industry trend which was done about 6% in the U.S.

Gerrick Johnson - BMO Capital Markets - Analyst

That is year-to-date, right?

Ray Arthur - LeapFrog Enterprises - CFO

The U.S. trend is yes.

Gerrick Johnson - BMO Capital Markets - Analyst

Okay. So we were running down about 20% after the first 6 months, right?

John Barbour - LeapFrog Enterprises - CEO

I am not sure Ray has that. We will get back to you on that.

Ray Arthur - LeapFrog Enterprises - CFO

I do not have that number with me.

Gerrick Johnson - BMO Capital Markets - Analyst

Really what I want to know is were toys up or down in the quarter?

John Barbour - LeapFrog Enterprises - CEO

Toys were down.

Gerrick Johnson - BMO Capital Markets - Analyst

Okay.

John Barbour - LeapFrog Enterprises - CEO

The toy business is down across the board at the moment just like the video game business, and our toy business was down. But we are also considering a bunch of transitions there, and we are excited about with the new products we shipped in to the market. Early read across the Touch Magic line has been pretty strong and we have a couple of winners across the rest of our toys business, so we are quietly optimistic for the quarter.



Gerrick Johnson - BMO Capital Markets - Analyst

Okay. And just a few more clarification things. What does robust point of sale mean? Does that mean up double digits, up triple digits, up single-digits? What does robust mean?

John Barbour - LeapFrog Enterprises - CEO

I think up triple digits would be absolutely incredible point of sale. Double-digit.

Gerrick Johnson - BMO Capital Markets - Analyst

Okay. And one more clarification. If we took out the tax benefit, what would have been EPS wise, \$0.51 something like that in the quarter?

Ray Arthur - LeapFrog Enterprises - CFO

The difference year-on-year is due to the increased tax benefit is \$0.05. I think on a static basis if you just looked at the current year it is 9. So it would be \$0.52, yes.

Gerrick Johnson - BMO Capital Markets - Analyst

Okay. Shift gears here. You are signing a lot of deals with third parties to provide content to the LeapPad. Are these deals platform agnostic, meaning do they only apply to the LeapPad, or can you use this content for any platform either present or future platforms you may have coming out?

John Barbour - LeapFrog Enterprises - CEO

All of the deals that we have are quite unique depending upon how they come together, but today they cover all of our Explorer --- each of the deals has a definition. A few products that cover across that content, so some of them have Tag in there, some of them have the Explorer content which of course covers both the GS and LeapPad part of our businesses.

Ray Arthur - LeapFrog Enterprises - CFO

LeapPad1 and LeapPad2.

Gerrick Johnson - BMO Capital Markets - Analyst

Okay. Anything coming out next year?

John Barbour - LeapFrog Enterprises - CEO

That is a tough question to answer. But I would say certainly in the tablet space yes.

Gerrick Johnson - BMO Capital Markets - Analyst

Okay. Thank you.



Operator

Your next question is from Ed Woo.

Ed Woo - Ascendiant Capital - Analyst

Congratulation on the quarter.

John Barbour - LeapFrog Enterprises - CEO

Thank you, Ed.

Ed Woo - Ascendiant Capital - Analyst

I have some questions about International versus U.S. It looks like you have pretty good growth in both business. Was there any big difference in terms of reception to the LeapPad, and has the LeapPad2 been rolled out in all International markets yet?

John Barbour - LeapFrog Enterprises - CEO

No big difference in the reception to the product. It is just those markets are in different stages. We have launched the LeapPad in all of our English speaking market places, and for the first time we have actually launched it also in France where we launched the LeapPad1 in France not the number 2, so far it has been a terrific success.

Ed Woo - Ascendiant Capital - Analyst

Do you have plans to be rolling out the LeapPad2 in non English speaking countries relatively soon or is that something that will be done more for next year?

John Barbour - LeapFrog Enterprises - CEO

For sure we are not going to be doing anything between now and the holiday season, and we will certainly look market by market next year as to when we actually get a chance to review the performance of how we have done through the end of this year as we go forward. As you can imagine, localization for us is quite different than developing most of the toys where it just a packaging change and a instruction change.

For us we actually have to go and make significant changes to localize the curriculum, localize all the content, et cetera, so we take each of those moves very seriously in terms of our investments, and we are looking at it. We see a lot of opportunity as we move in to the future to expand globally. So far so good on France. Our team in France have done a terrific job over there. Our early reads into the product have been so exciting.

Ed Woo - Ascendiant Capital - Analyst

I am glad to see you are promoting harmony between Parisians and Americans over there.

John Barbour - LeapFrog Enterprises - CEO

I think it helps I am a Scot.



Ed Woo - Ascendiant Capital - Analyst

Last question I have. There has been a very good focus for you guys on digital content on app stores. I was just wondering have you seen a big shift in terms of people moving away from the cartridges and being exclusively on digital, or do you see your LeapPads still promoting both software?

John Barbour - LeapFrog Enterprises - CEO

We are fortunate our cartridge business is way up year-on-year, and we are excited about the plans that we have for that business. What we find is consumers tend to chose what they want at the time, and I think that is the great thing about our businesses being highly focus on the consumer and giving that consumer the choice of how and where they want to shop. It is funny, people for some time now have had this big expectation our cartridge business is going to wane, and that is just not true. Mom's love cartridges. They are there. They are easy to interface across different products. They are easy for children to share. They are something substantial that kids can hold in their hand, and every so often they lose them and it is pain, but cartridges are still a big favorite for today's mom.

Ed Woo - Ascendiant Capital - Analyst

Great. Thank you. And good luck.

John Barbour - LeapFrog Enterprises - CEO

Thank you.

Operator

Your next question is from Liz Pierce of ROTH Capital Partners.

Elizabeth Pierce - ROTH Capital Partners - Analyst

Thanks. Good afternoon. Nice job on the quarter. I just have a couple at this point. On the R&D, that was a little bit more than I anticipated, so I was curious about your costs not only for Q4 but for next year on how we should be thinking about R&D?

John Barbour - LeapFrog Enterprises - CEO

It is interesting as you can imagine, Liz, as you get more success and your eyes open to some of the other big opportunities that are out there. It does give us a chance to look at some exciting new things for next year. And we are pretty famous I think as a Company of coming up with revolutionary formats to extend our business. As we sit and look at it we have a couple of things we are working on that we are investing some money on for the future. We are pretty excited, and you will see all of those when we launch them in April of next year.

Elizabeth Pierce - ROTH Capital Partners - Analyst

Okay. I think I was under the impression that as content became a greater part of the mix that may be the R&D would start to come down a bit --



Ray Arthur - LeapFrog Enterprises - CFO

Content and development actually ends up in R&D.

John Barbour - LeapFrog Enterprises - CEO

Yes. Content and development is part of the that too. The answer to it is that our R&D expenditure will develop as we look at new opportunities that come up. Some years it will be higher, some years it will be lower. The goal long-term will be it have a lower percent of sales. If you look at our results so far and how we have invested for over the past couple of years and some new things have popped up that we are real interested in and we are going to continue to invest as we go forward.

Elizabeth Pierce - ROTH Capital Partners - Analyst

Okay. Can you speak to the margins by country or by the U.S. versus Internationally just directionally?

Ray Arthur - LeapFrog Enterprises - CFO

Not really. One of the things we have not covered traditionally is margin by area, and for competitive reasons I think we would probably not like to go into that.

Elizabeth Pierce - ROTH Capital Partners - Analyst

But doesn't that typically come out of a 10-Q; U.S. versus International?

Ray Arthur - LeapFrog Enterprises - CFO

Right. That does, yes.

Elizabeth Pierce - ROTH Capital Partners - Analyst

I guess that was what I was really asking for, not necessarily by product.

Ray Arthur - LeapFrog Enterprises - CFO

One second.

Elizabeth Pierce - ROTH Capital Partners - Analyst

Maybe while you are looking at that, if you have any comments on your inventory for the LeapPad1.

John Barbour - LeapFrog Enterprises - CEO

LeapPad1? Inventory in LeapPad1, we have a very clear transitioning strategy here where we are requiring to bring the price down to \$79.99 in the market place, which we have done, and it continues to sell very well. And we believe that we will be pretty much out of it on shelf before the end of the year.



Elizabeth Pierce - ROTH Capital Partners - Analyst

Okay.

Ray Arthur - LeapFrog Enterprises - CFO

As to margins, margin is going to be up Internationally by 150 basis points and it is going to be down in the U.S. by 160 basis points. The end of life inventory allowances are primarily in the U.S. segment. They are not allocated out to International.

Elizabeth Pierce - ROTH Capital Partners - Analyst

Okay. Great. Thanks. That is all I have. Thanks, and best of luck.

John Barbour - LeapFrog Enterprises - CEO

Thanks, Liz.

Operator

Your next question is from John Taylor of Arcadia Investor Corps.

John Taylor - Arcadia Investment Corporation - Analyst

Hi, everybody. Welcome, Ray

Ray Arthur - LeapFrog Enterprises - CFO

Thanks, JT.

John Taylor - Arcadia Investment Corporation - Analyst

Nice to see you here. Nice job in the quarter from here too. I have a couple of questions. I want to pick up on where Sean was trying to go on this inventory thing. If you take a look, don't I recall there was some concern about a supply constraint on inventory earlier in the year and you have a nice base here that you can feed out as demand shows up. Given where your guidance is, it is one of the lower turn over rates of Q4 costs of good to inventory, not that necessarily means anything because you can air freight stuff, but it is one of the lower numbers, and it seems like, maybe you have built them for the first half so you do not end up empty handed in case things sell through. But I wonder could you give us any more color on that?

John Barbour - LeapFrog Enterprises - CEO

I think, JT, we have covered the base which is bottom line of it is we have better supply chain than we had last year. We are certainly want to have inventory going through into the first quarter. We do not want to be like last year where we left the shelves empty for about six weeks of the beginning of the year, and if we really desperately need it, we can air freight inventory in. It is all part of the plan.



John Taylor - Arcadia Investment Corporation - Analyst

Okay.

John Barbour - LeapFrog Enterprises - CEO

At the same time, JT, nobody wants to do air freight to keep product in warehouses or put it on shelves if it is not selling. So all of this is going to be determined by what consumer demand is of the product and how much of that demand was sucked up early by all of these layaway programs. We are trying to manage the business as tightly as possible.

John Taylor - Arcadia Investment Corporation - Analyst

Okay, cool. And then the economics on the Lionsgate film production and so on. Can you give us any rough idea of how much you expect one of these to cost to actually do?

Ray Arthur - LeapFrog Enterprises - CFO

No.

John Taylor - Arcadia Investment Corporation - Analyst

Not yet?

Ray Arthur - LeapFrog Enterprises - CFO

Not yet.

John Barbour - LeapFrog Enterprises - CEO

Confidential. Sorry.

John Taylor - Arcadia Investment Corporation - Analyst

Are those costs most likely going to be expensed or capitalized until it ships? The way that Hasbro does with the Hub programming stuff like that.

Ray Arthur - LeapFrog Enterprises - CFO

We will capitalize them until it is out to market.

John Taylor - Arcadia Investment Corporation - Analyst

Okay. Good. Last question, the ad-to-sales number in the Q4 seems like you made it pretty clear you are pushing some of that -- sorry. In Q3 you have pushed some of that into Q4. Is the Learning Path doing anything for you in terms of lower ad to sales?



John Barbour - LeapFrog Enterprises - CEO

Yes. It helps us a build a relationship with the customer and helps us build community. I think you are going to see a lot more of that in the future. But absolutely the Learning Path program and our direct relationship with those consumers through Learning Path is helping us communicate more effectively with our customer base.

John Taylor - Arcadia Investment Corporation - Analyst

Would you tie that partly to the low ad to sales ratio in Q4 or probably not?

John Barbour - LeapFrog Enterprises - CEO

No . I think it is just more tactical managing the business on a day-to-day basis.

John Taylor - Arcadia Investment Corporation - Analyst

Okay. Great. Thank you much.

John Barbour - LeapFrog Enterprises - CEO

Any time.

Operator

Your last question comes from Drew Crum of Stifel Nicolaus.

Drew Crum - Stifel Nicolaus - Analyst

Good afternoon, everyone. Just a point clarification on the guidance. Does it include or exclude the tax benefit you recognized in the third quarter?

Ray Arthur - LeapFrog Enterprises - CFO

It includes the tax benefit.

Drew Crum - Stifel Nicolaus - Analyst

Okay. Got it. And, JB, any impact from Hurricane Sandy on your business? Is that contemplated in anyway in the guidance you provided?

John Barbour - LeapFrog Enterprises - CEO

That is a real tough one because I think things are still passing through at the moment. I think a lot of it depends upon how quick the East Coast recovers. I can give you an example. My home has had no energy at all until this morning, and there are still probably millions of people that do not have energy and have difficulty getting access at the moment. If that continues, it is highly likely to have an impact across the market place, but none of us really know that.



Drew Crum - Stifel Nicolaus - Analyst

Okay. Fair enough. Last question, as far as TIE ratios are concerned for the LeapPad2 can you compare that versus your experience with the LeapPad1? Is it too early to say?

John Barbour - LeapFrog Enterprises - CEO

Yes, too early to say.

Drew Crum - Stifel Nicolaus - Analyst

Okay. Fair enough. Thanks, guys.

John Barbour - LeapFrog Enterprises - CEO

Thank you.

Karen Sansot - LeapFrog Enterprises - Senior Director of IR

Operator, are there any other questions, or was that the last question?

Operator

There are no further questions at this time.

Karen Sansot - LeapFrog Enterprises - Senior Director of IR

Great. Well, thank you, everyone, for joining us on our call today.

John Barbour - LeapFrog Enterprises - CEO

Thank you.

Karen Sansot - LeapFrog Enterprises - Senior Director of IR

Please feel free to contact Ray or me with any follow-up questions. Thanks and goodbye.



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