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LF - Q1 2013 LeapFrog Enterprises, Inc. Earnings Conference Call

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OVERVIEW:

LF reported 1Q13 worldwide net sales of $83m, net loss of $3m and net loss per basic and diluted share of $0.04. Expects 2013 net sales to increase high-single-digit percentage vs. 2012 and GAAP and normalized income per diluted share to be $0.57-0.60.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning. My name is Steve, and I will be your conference operator today. At this time, I would like to welcome everyone to the LeapFrog first-quarter 2013 earnings conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions) Thank you.

I'll now turn the conference over to Ms. Karen Sansot, Senior Director of Investor Relations. Please go ahead.

Karen Sansot - *LeapFrog Enterprises, Inc. - Senior Director, IR*

Thank you. Good morning, and welcome to the LeapFrog Enterprises conference call to review our results for the first quarter ended March 3, 2013. I'm 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 quick housekeeping item to go over. Our closed communication period, during which we will be unavailable to talk with investors or analysts about our business, will begin on Monday, July 1, and will last until we announce our second-quarter results, which we anticipate to announce in early August.

And now the safe harbor statement. We wish to remind you that our statements today will include forward-looking statements, including Management's expectations regarding anticipated second-quarter and full-year 2013 financial results. 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, May2, 2013, and disclaims any duty to update them.

I would now like to turn the call over to John Barbour.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

Thank you, Karen, and a good morning to everyone.

As the CEO and a shareholder of LeapFrog, I am very pleased with our performance in Quarter 1 and the progress that we're making on our 2013 initiatives. During the quarter we delivered solid sales, earnings and cash flow growth, while making significant long-term investments in our business. Our life-changing learning solutions continued to be recognized for their exceptional education and entertainment value, receiving many prestigious awards. And we launched a 2013 multimedia product line to our major retail partners around the world. Their feedback was very positive.

While it's early in the year, we're tracking to a successful 2013. And more importantly, we're investing in our future, so we can extend the leadership in the children's education entertainment business and further strengthen our foundation for growth. All of us at LeapFrog have a deep passion for creating the best learning solutions that help children around the world achieve their potential, while also creating significant value for our shareholders.

Now I want to take a few minutes to talk about our first-quarter performance. We delivered market-leading net sales growth of 15% year on year, despite challenging economic conditions in most of the markets in which we operate. Our net sales in the US increased by 11% and by 26% in international markets. Net sales had strong double-digit growth in each of content, platforms, accessories, and toys.

Content was the largest driver of our sales growth, as we continued to capitalize on an installed base of millions of connected multimedia learning platforms. In addition, accessory sales for our platforms had exception growth and were up 55% year on year. Both content and accessories increased as a percent of our total sales mix.

Content and accessory sales were driven in part by our late December and January retail promotional activities, which we call our Q5 programs, that are designed to create a [sell-through] of additional content and accessories for the new platforms that were received as holiday 2012 gifts. Our Q5 initiatives for this year included having more displays and end-caps, incremental retail facings, more catalog placement, and greater online marketing plans, including direct emails to our millions of connected customers.

As a result of our sales growth and continued cost control, we improved our operating results by 47% and were EBITDA-positive in the first quarter for the first time since 2003. We delivered $69 million of free cash flow, which was up 12% year on year, even with our expenditures for long-term investments.

Speaking of investments, this year we're making significant long-term investments in content, new business categories, line refreshments and extensions, international expansion, online communities, and internal operating systems.

Within content, we're creating significantly more titles and offering those titles across many different form factors. We're investing in our own intellectual property to expand the awareness of our current portfolio of lovable characters and to create new characters.

We're making great progress in the first of our four new DVD movies from the deal we announced with Lionsgate in November 2012. A couple of weeks ago I saw the first animation clips from the studio, and they look fantastic.

In addition, we're expanding our distribution relationships with third-party partners and expect to have over 800 educator-approved titles in our library by the end of this year. We also continued to explore the potential of delivering our extensive library of educational entertainment content to other platforms such as Apple and Android devices.

LeapFrog has an exceptional brand and track record in delivering the absolute best in children's educational entertainment. We believe there are additional categories where we can [take] our proprietary education curricula and entertainment expertise and build new lines of business. We're currently working on some exciting new technologies that will help us deliver life-changing educational entertainment experiences in categories that we do not operate in today. More to follow.

We're also looking to expand our business internationally. Our international business has exhibited very strong double-digit sales growth over the last three years, which gives us confidence that our products have the opportunity to perform well in many of the geographies where we do not operate today. We're currently investigating new opportunities in Europe, Asia, and South America.

Today we have more than 13 million parents connected to our business. And many of them are keen for support and guidance on their children's development and educational journey. We're uniquely positioned to provide those parents with a safe and credible place to share those ideas, discuss their child's progress, and to get answers on important questions they may have. We're making good progress in building a new online community infrastructure.

Over the last two years our sales have grown over 30% and our business has become more complex. As we discussed earlier this year, we have big visions for this company, but are acutely aware that we need to have the operating foundation to support the potential growth. Over the next 12 to 24 months we're investigating and upgrading and expanding our internal business systems to provide us with a solid foundation for success.

But back now to some of our other accomplishments this year. As a result of our efforts and expertise in developing the best educational entertainment for children, LeapFrog received some very prestigious awards in the first part of this year, which builds upon our track record of winning hundreds of industry, education, and parenting awards over our 18-year history.

In February, at the 13th Annual US Toy Industry Association's Toy of the Year Awards ceremony, LeapPad2 received the inaugural People's Choice Toy of the Year and the Education Toy of the Year awards. The People's Choice was the only award of the evening voted on exclusively by consumers. This award validates the popularity of our educational entertainment solutions with parents across the country. LeapFrog has now won Educational Toy of the Year 8 out of 13 years and has won a total of 18 Toy of the Year awards from the US Toy Industry Association.

In March, our learning game, Jake and the Never Land Pirates, received a 2013 ON for Learning Award from Common Sense Media, the national nonprofit dedicated to help parents and teachers manage the media and technology in children's lives. This esteemed honor is given to the top children's media products that receive the highest rating for the learning potential from Common Sense Media, based on research from leading experts in both educational and digital media.

Also in March, 6 of our learning games won Parents' Choice Spring Video Game Awards. LeapFrog won more Parents' Choice Video Game Awards then any other brand. The Parents' Choice Awards Committee evaluated top-quality products that entertain, teach, stimulate the imagination, and inspire creativity. The 6 winning titles were Phineas and Ferb, Letter Factory, Brave, Learn to Read Ultra eBooks, Adventure Stories and Fairy Tales, and Jake and the Never Land Pirates.

In Quarter 1 we also won a Walmart Supplier of the Year award. This is a very special achievement as it is awarded to only one company in the whole toy industry. It's a terrific recognition to the great job that our team did last year.

Building on our first-quarter momentum, in March we launched our 2013 multimedia product line to our major retail partners around the world, and we received a very positive global response. We've an exciting product line that provides the best educational entertainment that's aimed specifically for children, to be kid-tough, kid-safe, and kid-fun -- and most importantly, offers rich nutritional education.

And just this week we unveiled our LeapReader line of learn-to-read-and-write products at two major media events in New York City. Many influential consumer, business, and tech media journalists and bloggers attended these events. The LeapReader line received extremely positive feedback and some great early media coverage.

In June, like the last couple of years, we will announce to consumers our new tablets, toys, and content for the second half of 2013.

So in summary, we're off to a great start and making really good progress on our 2013 business plans. We delivered solid first-quarter financial results, continued to receive prestigious awards, and made investments in key long-term opportunities. We're passionate about helping children achieve their potential. That's why the LeapFrog team continues to drive innovation and excellence in children's learning solutions and why we're keenly focused on building for the long term.

I'd like to finish by thanking all of the dedicated LeapFrog employees around the world for their passion for helping children achieve their potential and an incredible commitment to our business. I'm very proud of the progress we've achieved together.

Now I'll turn the call over to Ray Arthur, LeapFrog's CFO, who will talk about our Q1 performance and 2013 outlook in more detail.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Thank you, John, and good morning, everyone.

I am pleased to report that LeapFrog turned in a strong performance for the first quarter of 2013. The performance was due in part to restocking efforts by retailers after a strong 2012 holiday season, consumer sell-through, and an earlier Easter this year than last. While the first quarter is seasonally insignificant relative to our full-year business, we are encouraged by these results and believe that we are on track to achieve our 2013 business plans.

Worldwide net sales for the quarter were $83 million, up 15% compared to last year's $72 million in sales. The impact on net sales from changes in currency exchange rates was immaterial. The worldwide growth was driven by strong double-digit sales growth of content, platforms, accessories and toys.

Net sales for our US segment were $58 million, up 11% compared to the $52 million reported a year ago. Net sales growth in the US segment was largely driven by increased sales of platforms, content, accessories and toys. This performance was particularly offset by higher defective return allowances in Q1, primarily due to a large increase in platforms sold in the fourth quarter of 2012 versus 2011.

In our international segment, net sales were $25 million, up 26% compared to the $20 million reported a year ago. Changes in currency exchange rates did not have a material impact on sales. Our sales growth was driven by increased sales of platforms, content and accessories. This sales performance was partially offset by higher trade discounts and allowances.

By business line, worldwide net sales of multimedia learning platforms and content, which includes tablets, game systems, reading systems, content, and accessories, increased 17% year over year. Sales of content and accessories as well as LeapPad hardware were particularly strong and more than offset expected declines in older platforms that we are transitioning out of, such as Leapster2 which is a 5-year-old gaming platform that has been replaced by LeapsterGS, and Tag, which is also a 5-year-old learn-to-read system that will be replaced by LeapReader, our new learn-to-read-and-write system, in mid-2013.

Learning toy net sales increased 23%, reflecting the sales of our new Touch Magic toy line introduced in 2012 and improved sales in our Milestones and Scout toy lines.

Turning to gross profit, for the quarter it was $33 million, an increase of 12% compared to the $30 million reported for the prior year.

Gross margin was 40.2%, down 110 basis points year over year. Gross margin was favorably impacted by higher sales volume resulting in fixed cost leverage as well as lower freight and warehousing costs. This was more than offset by higher trade discounts and allowances, which were due to a couple of reasons.

First, we had higher sales growth in international markets that have higher discount and allowance rates. And, second, as a result of far higher tablet sales in the fourth quarter of 2012 versus the fourth quarter of 2011, our trade allowances for defectives and returns were higher in the current quarter.

Additionally, gross margin was negatively impacted by a higher mix of sales of third-party distributed content, which carries a lower gross margin than on our other content but generates a high operating margin given its revenue share model.

Operating expenses for the quarter were $38 million, flat compared to the $38 million reported a year ago, and are down 750 basis points as a percentage of net sales. Operating expenses in the first quarter of 2012 included a $3 million bad debt expense related to an isolated customer bankruptcy. Excluding this expense, operating expenses would have increased 8% year on year.

SG&A decreased 8% primarily due to the $3 million bad debt expense we incurred in the first quarter of 2012 which we did not incur again in 2013. Excluding this expense, SG&A would have increased 6% year on year due to higher headcount-related expenses.

R&D expenses increased 1% due to higher headcount-related costs as we continue to invest in our product development.

Advertising, including our marketing and retail programs, increased about $2 million year on year, or 72%, as Easter occurred in the first quarter of 2013 compared to the second quarter of 2012. We also had bigger Q5 marketing initiatives this year, including more online and social marketing. While the advertising growth rate sounds high, it's primarily due to timing and the impact of shifting advertising dollars to a period that has a very small base. We expect our advertising-to-sales ratio to remain flat for the year compared to the prior year.

Net loss was $3 million, an improvement of $6 million over the $9 million loss reported for the prior year. Net loss per basic and diluted share was $0.04, an improvement of $0.10 compared to the $0.14 net loss a year ago.

Normalized net loss per basic and diluted share was $0.05, an improvement of $0.04 year over year. Normalized earnings have been adjusted to reflect an effective tax rate of 37.5%. In the first quarter of 2013, normalized net loss per share was different than GAAP net loss per share by $0.01 primarily due to a discrete tax benefit related to an expiring statute of limitations that falls out of the normalized calculation when you move to a 37.5% rate.

Adjusted EBITDA, which is EBITDA adjusted for stock-based compensation, was $2.4 million, an improvement of $3.5 million year over year and the first positive EBITDA the Company has seen in the first quarter since 2003.

Operating cash flow was $77 million, up 17% year on year, and free cash flow, defined as operating cash flow less capital expenditures, was $69 million, up 12% year on year.

Now let me spend a moment on the balance sheet. Cash and equivalents, which peaked at $212 million during the quarter, finished at $190 million, an increase of $55 million compared to a year ago period.

Our accounts receivable balance was $57 million, flat with last year on increased sales. Our portfolio is in good shape and our days sales outstanding improved over the year-ago period by 10 days, to 62 days.

Our inventory balance was $45 million, up $6 million, or 16%, compared to a year ago. Remember, our inventory consists of top-quality products, and recall also that last year we had too little inventory. Overall, we believe both LeapFrog and retail channel inventories are at appropriate levels to meet consumer demand.

Deferred taxes increased $22 million due to the reversal of a portion of the valuation allowance against our deferred tax assets in the fourth quarter last year and we still maintain approximately $70 million in valuation allowances against our deferred tax assets that in essence are not on our balance sheet.

Accounts payable is down $9 million due to the timing of vendor payments.

And, in summary, our balance sheet is in excellent shape.

I'll finish our prepared remarks with our outlook. We expect net sales in the second quarter to increase at a mid-to-high single digit growth rate compared to a year ago. The growth rate will moderate from the first quarter as we have entered our traditionally slowest retail take-away quarter of the year. All Easter sell-in occurred in the first quarter of 2013, and we plan to transition out of a number of products in the quarter to prepare for new product launches this summer.

Additionally, we expect an increase in operating expenses year over year due to higher headcount-related costs supporting our higher sales volume and our investments in the future. As a result, we expect second-quarter GAAP and normalized net loss per basic and diluted share to be in the range of $0.10 to $0.08 compared to a GAAP net loss per basic and diluted share of $0.12 a year ago and a normalized net loss per basic and diluted share of $0.07 a year ago.

Remember, our annual business cycle really consists of two halves. The first half of the year is seasonally small while the second half benefits from holiday shipments and holiday sales. In the first half of the year, small fluctuations in the timing of shipments for expenditures between quarters can have a big impact on our results. For example, we believe that our Q1 sales benefited this year from the timing of Easter, which occurred in March this year compared to April last year.

Therefore, we suggest you look at our results on a first and second half basis. With our first-quarter actual results and second-quarter guidance, our implied first-half estimated net sales growth rate is approximately 10% to 12%. Our implied first-half GAAP net loss per share improvement is expected to be $0.12 to $0.14, which includes the $0.10 year-over-year improvement in Q1, plus the estimated $0.02 to $0.04 year-over-year improvement in Q2.

Our implied first-half normalized net loss per share improvement is expected to be $0.01 to $0.03, which includes the $0.04 year-over-year improvement in Q1 minus the estimated $0.01 to $0.03 year-over-year decline in Q2.

For the year, we are reiterating our guidance. We expect net sales to increase at a high-single digit percentage growth rate compared to 2012. We expect operating margins to be relatively flat to 2012 as we make long-term investments in content, new business categories, international expansion, online communities and systems. We expect operating income improvement to be driven largely by net sales growth.

We are expecting other expense of about $2 million, which is consistent with 2012. And, as a result, we expect net income per diluted share to be in the range of $0.57 to $0.60 for both GAAP and normalized net income per diluted share, excluding any potential discrete tax adjustments related to our tax valuation allowances. That would be compared to a GAAP and normalized EPS for 2012 of $1.24 and $0.56, respectively.

Lastly, we are early in the year of a highly seasonal business. And, while we are planning for growth, we will continue to manage our business prudently until we have better visibility into the holiday season.

As we look to the rest of 2013 and beyond, we believe that we are well positioned to grow our earnings and deliver strong cash flow. We are the leader in children's educational entertainment, with a brand that parents and children love. We have the best learning solutions, exciting new projects and many growth opportunities.

That concludes our prepared remarks. And we'd now like to open the call for questions. Operator, who would like to ask the first question?

QUESTIONS AND ANSWERS

Operator

Lee Giordano; Imperial Capital.

Lee Giordano - *Imperial Capital - Analyst*

In terms of the investments you're making this year and the increased costs, can you just talk about what might be temporary in nature and what might be investments that you will continue to make where that will flow through in years following? Thanks.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

Well, if you break down the area where we're spending money -- good morning, Lee -- in terms of content, the plan would be as we build out our base of multimedia systems around the world we certainly see a growing demand for high-quality content. So we see a lot of content investments that certainly continue multiyear. And that's kind of one area.

As you look at the other areas in terms of systems and internal systems, I think there's always an ongoing cost of internal systems. But there's some significant investments at the moment in our new ERP system and things that are going to be a little bit more short term.

And as you sit and you look at investments in building our community, those will be a little bit more front loaded, but there will be some ongoing costs as well.

And then in terms of getting into new categories and new marketplaces, they both also tend to be front-end loaded, especially when you're developing new technology or you're starting to go into a new marketplace. An example would be Asia, as you're starting to develop a new English-as-a-second-language curricula.

So I would say they're going to be spread across -- certainly more up front, but a number of them do have a back-end aspect of it. But the goal would be that the businesses are large enough to sustain that ongoing investment as we go forward.

Lee Giordano - *Imperial Capital - Analyst*

Great. That's helpful. And then, secondly, you ended the first quarter with almost $3 a share in cash on the balance sheet. Can you just talk about how you're thinking about using that cash going forward, either for potential acquisitions or a buyback, just how you're thinking about that? Thanks.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

We do have quite a bit of cash on the balance sheet. But I think, as we've stated before, we're very interested in growing the business and supporting our growth initiatives. So we'll continue to look for acquisition opportunities opportunistically. We'll continue to invest in our content, in our online communities and systems. At the end of the day, we continue to look at whether any kind of stock buyback might be appropriate. I don't think that's a short-term initiative for us. I think we have better uses for that cash than returning it at this point in time.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

I totally agree. I mean, if you look at this marketplace, there are very few companies that are growing as fast as we are. Just look at the results in the first quarter. This is a company, if you look at the last two years, has certainly been on fire. And we're growing the marketplace. One of the advantages we're in is we're the [main] marketplace for supplemental education space that's growing faster than the toy space.

So that cash that we have there is going to be real important as we continue to grow our business. And I think certainly key for us, as I said, to continue to build cash and invest it where wisely and chasing that growth where the water's rising.

Lee Giordano - *Imperial Capital - Analyst*

Great. Thank you.

Operator

Drew Crum; Stifel Nicolaus.

Drew Crum - *Stifel Nicolaus - Analyst*

I wonder if you could start by putting some numbers around your point of sales in the first quarter. And if you look at the second quarter are you going to be shipping any new products, namely the LeapReader?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

We had solid POS in first quarter on a worldwide basis. We're very happy with it. I think we will be shipping in a number of new products in second quarter, LeapReader being probably the biggest introduction in Q2.

Drew Crum - *Stifel Nicolaus - Analyst*

Okay. And accessories seemed to have a very good first quarter and sounds like it's becoming a more meaningful piece of your business. How is that impacting the gross margin? And as you look out for the balance of 2013, how are you thinking about gross margin for the year?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

I think in our business, as you know, the more content and the more accessories we sell as a share of our business, that the higher our blended margin becomes in the main. And you've got to remember that last year we had a small range of accessories. It was just the first holiday season, post-holiday season, after launching original tablet. Our line of accessories this year was a lot more expansive. And we're very appealing. I mean, our Q5 initiatives driving accessory sales and content sales to the kids who got tablets and our gaming systems for Christmas and the holiday season was very strong.

And as you look at gross margin -- we've said this a few times -- there's a bunch of moving parts there that all have an impact. And more tablets reduces overall gross margin; more accessories, more content, especially [cartridge] content, lifts our gross margin. And more digital content in the main can have a detrimental impact, especially if we sell more third-party content, where we're on a rev share and therefore the gross margin aspect of that is lower than the rest of our business, or many parts of our business.

So our gross margin -- I've said this before -- I'm not sure that looking at gross margin in our business is the best way to look at our profitability. I'd be looking at operating profit, because each of those moving parts will have impact. And what we want to see is we want to see growth in our operating margins.

Drew Crum - *Stifel Nicolaus - Analyst*

Got it. Okay. And last question, JB, the toy category was kind of tough in 2012. Your business, your first quarter, up 23%. How are you feeling about that piece of the business now, looking forward?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

I think our new introductions for this year are better than they were last year. I think that Greg Ahearn and his team and the engineering team have done a lot of really good stuff for this year. So my expectation is our toy business is going to grow this year. It's an important first handshake with our customers.

And, as I say, a lot of it's down to the quality and innovation that we bring to the marketplace. And some years that's a little bit stronger than others. I feel especially good about toy line this year. And we've just finished looking at 2014 line as we get ahead of things here. And we've got some good stuff coming through for the future as well.

Drew Crum - *Stifel Nicolaus - Analyst*

Okay. Thanks, guys.

Operator

Sean McGowan; Needham.

Sean McGowan - *Needham & Company - Analyst*

I have a couple of housekeeping things first. Ray, can you tell us what the full-year fully-diluted share base would be, assuming that you're in the range of what you're forecasting?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Sure can. It is about 70.2 million shares.

Sean McGowan - *Needham & Company - Analyst*

70.2, okay. Thank you. And just to clarify, when you guys say that platform sales were also up double digits, do you mean that LeapPad hardware was up double digits in the quarter?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

We don't break it down into the individual components.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

It's LeapPad, it's Leapster; it's Tag. All of our platforms was up over double digits.

Sean McGowan - *Needham & Company - Analyst*

Okay, thanks. And, Ray, could you give us some sense in terms of order of magnitude or priority what the factors were on gross margin? Like, how much of the gross margin drop was due to the defective rate? And can you tell us internationally versus domestically, are the gross margins about the same or higher in one market versus another?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

We don't allocate certain things to international markets, so that the gross margin tends to be a little bit higher. They do, in the international markets, tend to have a higher gross to net discount, which has some impact.

The defectives are higher because of the number of platforms we sold into the market at the end of last year. But what I would say is that we're looking into that now. So I really don't want to get into the actual amount of the number of defectives. But they did have a negative impact on gross margin in Q1.

Sean McGowan - *Needham & Company - Analyst*

Do you think that's more of a Quarter 1 issue or a Q5 issue, if you will?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Well, obviously we sell more platforms in Q4, so it's going to be a Q1 issue. But, again, some of the stuff has just come through recently so we're actually digging into it now.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

But I think it's important to recognize here, Sean, that every Quarter 4 that we sell more hardware we're going to have a bigger impact in regular returns in the next quarter. And of course Quarter 1, which is our second lowest quarter of the year, is going to be impacted by that. And it's just part of the seasonal shift of our business as we go forward.

Sean McGowan - *Needham & Company - Analyst*

But I would expect, though, that you could take -- as your experience grows you could take a reserve in the fourth quarter about that so you wouldn't see a surprise in the first quarter.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Yes. Ultimately we'll be able to do that. But it's an evolving business in the high growth sales number, so sometimes it's hard to predict exactly what's going to happen when you're dealing with the kind of growth we're seeing.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

Yes. The other thing that's important, though, and I think that's what makes this unique [in] the way that we [sweat] the details is that -- and when you look at it last year, we really only had regular returns for one single product. This year we had the traditional product go from LeapPad1 to LeapPad2. And you know as well as I do that in retail world, that not everything that you get back is actually defective. Sometimes people have bought LeapPad 1, then LeapPad 2 comes along. And some people are said to bring those back and it's perfectly good product.

So we're going to go through and analyze that data right now. And as we go forward we'll try and get ahead of it.

Sean McGowan - *Needham & Company - Analyst*

Okay. Couple of others, then. How is SG&A down so much in the quarter?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

It's basically the $3.1 million, accounts receivable write-off that we had last year. It did not recur this year.

Sean McGowan - *Needham & Company - Analyst*

Okay. Got it. You did mention it. I didn't know if that was the whole reason.

And last question, harking back to the toy question, about the growth there, are you seeing the same kinds of growth in the US as you are seeing outside the US in that category? Or was it stronger outside the US?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

It was actually very strong in the US.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

You've got to remember, of course, Q1 is more of a fill than a PS quarter. So it actually reflects the sell-through of our product really at the end of 2012.

Sean McGowan - *Needham & Company - Analyst*

Right. Okay. I just didn't know if there was a lot more sales -- a lot more growth outside the US than in the US on that.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Yes, US was strong.

Sean McGowan - *Needham & Company - Analyst*

Okay. Thank you.

Operator

Michael Swartz; SunTrust.

Michael Swartz - *SunTrust Robinson Humphrey - Analyst*

Just wanted to maybe touch on your commentary around advertising spend for the full year. I think you said that as a percentage of sales it'll likely be flat. Could you maybe just give us some more color? I mean, you had a pretty decent size increase last year. How should we look at that playing out through the year?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

I think one of the things you look at is you look at the amount of new product we're launching in the marketplace. So until we actually announce publicly what's happening in the tablet front, it's hard to give you a little bit more detail on that. But the fact of it is, is that the more new systems you launch into the marketplace, the likelihood is your average spend in advertising is going to up year on year.

And we've got some new things that are going to happen later this year. But we're also starting to see efficiencies of marketing directly consumers through our network and through our direct relationship with customers.

So you're going to see a couple of those things playing this year. Launch of more new systems this year versus last year, which means that we're going to spend a little bit more money on those fronts. But then, just ongoing leverage that we're getting from those millions of consumers that are connected to our back end now is going to start to pay off as well. That's why we're saying our belief is we're going to be able to hold it flat as a percent of sales and you're going to see those big trends within the numbers.

Michael Swartz - *SunTrust Robinson Humphrey - Analyst*

And then, did you quantify the impact of the Easter shift on the top line?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

We did not. It's hard to kind of segregate exactly what is Easter sell-in versus replen and other things. So, no, we have not quantified that.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

I mean, it's certainly a benefit. How big a benefit, we'll see.

Michael Swartz - *SunTrust Robinson Humphrey - Analyst*

Okay. And then, final question, could you maybe give any additional color around some of the commentary you had said earlier in the call about some new categories you're looking at? I know you don't want to give away too much, but is there anything that you can maybe provide us?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

No.

Michael Swartz - *SunTrust Robinson Humphrey - Analyst*

All right. Easy enough.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

(Laughter) No, I mean, we've got some super cool stuff we're working on here, but absolutely we're keeping it ultra top secret. As you can imagine, lots of people are looking at us to try and copy the things we do. And we're having to become tighter and tighter, because everybody looks to the companies that are growing faster than everybody else for their ideas.

Operator

John Taylor; Arcadia.

John Taylor - *Arcadia Investment Corp. - Analyst*

I've got a few questions from me. Ray, I think you talked about third-party share of content going up. So can you give us any sense kind of what the percentage mix looks like, or kind of what you're thinking about this year versus last year? I don't care about what the timeframe is, but give us a sense of what the relative magnitude of those two categories and the trend line.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Well, it's increasing. We don't break it down between components for competitive reasons. I think the real story there is we're getting more choices for consumers, and that's a good thing. And it's being curated by our educational experts, which is a great thing. And ultimately, while it might have some depressive effect on gross margin percentage, it's very accretive to operating margin because we've got basically no costs associated with that third-party content.

John Taylor - *Arcadia Investment Corp. - Analyst*

Okay. All right. And then, it sounds like you're kind of alluding to a close-out of those 5-year-old platforms. So can you give us any sense of kind of what the revenue contribution of those looked like last year, and/or maybe what the first-half negative impact on closing that out might look like?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

No, I can't, unfortunately. I can say that anytime -- you know, the objective is to manage it as tightly as possible so that you can transition from one product to another and not miss a sale. It's a best laid plans of mice and men, of course. We do the best we can at it. The better we do, the less the impact. But ultimately quantifying that impact at this point in time would not be something that I can really do.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

The good news is that I can tell you from testing and from our media events this week, that the new LeapReader, which we see as a significant enhancement on our Tag, is going to be strong this year. We're really excited about it. I think the addition of the learn-to-write component and the ability to listen to stories is going to be a big addition to the product. Because when you think about it, it's all over that combined experience of learning to read, learning to write, and then the ability to listen to storybooks.

I mean, it's not just a small tweak to Tag. This is a major new product. And the response from the trade, the response from the media, the response from our testers, have all been incredibly strong.

John Taylor - *Arcadia Investment Corp. - Analyst*

Yes, it's kind of a three-in-one thing.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

It's awesome, I tell you. When they come out you should get one and try it. It is a big step up.

John Taylor - *Arcadia Investment Corp. - Analyst*

Okay. Let me ask two more, if I can. So JB, what's going on, what are you hearing from retailers on shelf space in the US, in particular for the ELA category?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

As we sit down and we look at shelf space for the fourth quarter, we're either holding or gaining space in our business. And there's no question that retailers are seeing our category as a strong category compared to some of the others that are out there. I mean, you've just got to look at the growth in our category and construction versus the decline in other parts of the business. So we're feeling good that we are holding or growing our space, shelf space, for the fourth quarter.

Where you're going to see some increases is in the amount of promotion support. People are definitely seeing our lines as good product lines for attracting families to the store. And that's where we've put a lot of focus, is really driving off shelf and (inaudible) line for this year.

John Taylor - *Arcadia Investment Corp. - Analyst*

Okay. Good. And then, last question -- so this new category that you're talking about but not talking about, can you give us any sense of the timing of when you might go into some detail on that? Is that a June event or is that down the road sometime?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

What category? (Laughter) Just kidding. No, it will be -- as you can imagine, at our June media event, we have a bunch of new stuff. Everybody will get a chance to see the multiple new tablets that we've launched and we've already shared with our major customers and had a great response to. Everybody will see that in June and then there will be new stuff coming through for 2014.

I mean, I can tell you that we are further ahead in our product development than we've been for years. We are getting ahead of this and I think that's going to help us in the long term. So we're constantly -- as our business grows we're still constantly trying to drive the operational excellence of our business.

John Taylor - *Arcadia Investment Corp. - Analyst*

Okay, great. Thank you.

Operator

Ed Woo; Ascendiant.

Ed Woo - *Ascendiant Capital Markets - Analyst*

It looks like your international grew pretty well this quarter again. Is there any change in accelerating the roll out of LeapPad2 across international geographies?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

This year we'll be launching LeapPad2 in France. So there will be an acceleration in that front. And it will go into, I think, some of our smaller distributor marketplaces. But beyond that, nothing significant for this year.

Ed Woo - *Ascendiant Capital Markets - Analyst*

Okay. And another question I had is, (inaudible) year to year you've been doing a great job of growing your [distribution] beyond traditional toy companies or toy retailers. How do you see that progressing this year, especially as you roll out more product and more content?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

The bulk of our product are still going to be sold through the customers we had last year. And so we did an expansion last year in Best Buy, an expansion last year at GameStop. We see those opportunities continuing. But I don't see it having a dramatic impact in the mix of our retail business across the board.

Ed Woo - *Ascendiant Capital Markets - Analyst*

Okay. Thank you.

Operator

Last question; Jim Chartier; Monness, Hardt.

Jim Chartier - *Monness, Crespi, Hardt & Co. - Analyst*

I have a couple questions. Is there an opportunity to lower the defective return rate going forward?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Like I said earlier, we just recently started looking into that rate. So we're not even sure it's right at this point, honestly. We're going to go investigate the drivers behind it. It's funny with defectives; it can be defectives, it can be returns, right? Because what happens in the store is a customer walks back in, maybe they bought a LeapPad1 and they want to upgrade to a LeapPad2. So whether it's a return or whether it's a defective, we've still got to hash through some of that information.

But we're always driving to maintain a defective rate that's as low as humanly possible. And you've seen us before take a LeapPad 1 and throw it against the wall. It doesn't break generally.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

But actually, I mean, one of the things we have to clarify here is, just so everybody's super clear, the defective rate at the moment in the first quarter is driven by the amount of tablets we place into the marketplace, first of all. It's driven by two things -- the amount of tablets and the level of defectives. In the first quarter if we sell a lot more tablets than the previous fourth quarter, we are going to have a higher defective number in our business, unless there's some dramatic change to the quality of our product. And I think that's real important.

What you're seeing here at the moment is not a dramatic change in the rate of the defectives, you're seeing a difference in the amount of defectives because of the amount of tablets. And we're analyzing it right now.

Jim Chartier - *Monness, Crespi, Hardt & Co. - Analyst*

Great. And did you say that the multimedia segment was up 17% and toys was up 23% for first quarter?

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Yes. Multimedia was up 17% and learning toys were up 23%. And if you're wondering why the overall sales isn't up a little more, it's because there were some miscellaneous sales categories that went down, very small, but had an impact.

Jim Chartier - *Monness, Crespi, Hardt & Co. - Analyst*

All right. And then, finally, should we expect to see at retail in the fall both a LeapReader and Tag at retail, similar to what we saw with the LeapPad2 and 1 this past year?

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

No.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

No.

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

We're transitioning LeapReader in and we're transitioning Tag out.

Jim Chartier - *Monness, Crespi, Hardt & Co. - Analyst*

Okay, but --

John Barbour - *LeapFrog Enterprises, Inc. - CEO*

It's going to be a replacement.

Jim Chartier - *Monness, Crespi, Hardt & Co. - Analyst*

Thank you. Best of luck.

Operator

And this concludes the Q&A portion of today's call. I'll turn the call back to Karen Sansot.

Karen Sansot - *LeapFrog Enterprises, Inc. - Senior Director, IR*

Thank you, everyone, for joining us on the call today. Please feel free to call Ray or me with any follow-up questions. Goodbye.

Ray Arthur - *LeapFrog Enterprises, Inc. - CFO*

Thanks.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.
