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# **EDITED TRANSCRIPT**

LF - Q2 2013 LeapFrog Enterprises, Inc. Earnings Conference Call

EVENT DATE/TIME: AUGUST 01, 2013 / 9:00PM GMT

# **OVERVIEW:**

Co. reported 2Q13 worldwide net sales of \$83m, net loss of \$3m and net loss per basic and diluted share of \$0.05. Expects 3Q13 net sales to increase mid-to-high single digit growth rate vs. 3Q12 and 2013 GAAP and normalized income per diluted share to be \$0.57-0.60.



#### CORPORATE PARTICIPANTS

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

John Barbour LeapFrog Enterprises, Inc. - CEO

Ray Arthur LeapFrog Enterprises, Inc. - CFO

#### CONFERENCE CALL PARTICIPANTS

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Drew Crum Stifel Nicolaus & Company, Inc. - Analyst

### **PRESENTATION**

#### Operator

Good afternoon. My name is Dean and I will be your conference operator today. At this time I would like to welcome everyone to LeapFrog Q2, 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. Karen Sansot, Senior Director of Investor Relations, you may now begin your conference.

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

Thank you. Good afternoon, everyone, and welcome to the LeapFrog Enterprises Conference Call to review our results for the second quarter ended June 30, 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, September 30th. It will last until we announce our third quarter results, which we expect to announce in early November.

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 quarterly 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 August 1, 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 good afternoon, everybody. As the CEO and a shareholder of LeapFrog, I am pleased with our performance to date and the progress we're making on our 2013 strategic initiatives.

Despite economic headwinds and weak industry trends year-to-date we continue to post market-leading results.

In the first half of this year, we delivered solid sales, earnings and cash flow growth. We launched in 2013 our multimedia product line to our retail planners, press, investors and industry influences around the world and their feedback was exceptionally positive.

And the consumer demands for our new LeapReader, Reading and Writing System and LeapPad Ultra tablet in recent online pre-sales has been excellent. We added over 250 new pieces of top quality content to our learning library and our life changing learning solutions continue to be recognized for their exceptional education and entertainment value receiving many prestigious awards.

While we still have around three-quarters of our year's sales ahead of us, we're on track to have a successful 2013.

Now let me take a few minutes to talk about our first half performance. We delivered market-leading net sales growth of 16% year-on-year despite challenging economic and industry conditions in most of the markets in which we operate.

Our net sales in the US increased by 15% and our net sales in international markets increased by 17%. In the first half of the year we delivered double-digit net sales growth in our multimedia leaning and learning toy businesses.

More specifically within the multimedia learning business, we delivered double-digit net sales growth in each of the content, platforms and accessory segments. As a result of our net sales growth and continued expense control, we improved our operating results by 41% and are EBITDA positive in the first half of the year, which is the first for LeapFrog in our 11 years as a public Company.

We delivered \$79 million of operating cash flow, up 29% year-over-year, while also delivering \$61 million of free cash flow, up 19% year-over-year.

The sales growth we achieved in the first half significantly outpaced the traditional toy industry. We believe this is a direct result of our strategic business shift over the last two to three years into the children's educational entertainment market.

Our current portfolio of learning's solutions spans several different entertainment categories such as kids learning tablets, education gaming systems, reading and writing systems, videos, toys, books, music, software cartridges and then mobile apps with many more children's entertainment categories offering potential growth opportunities for us in the future.

The success of our learning solutions stands from the growing body of research that shows the critical importance of early childhood development, the concern amongst parents about the quality of education our young children are receiving and increasing competitiveness in higher education and ultimately the workplace. Parents want to have their children get the best start in life and they understand that early success in education is critical. As a result, parents are looking for supplemental learning solutions for their children when they're not at school.

With a leading educational entertainment portfolio, LeapFrog is well positioned to fulfill this need. We have an 18-year heritage of making the best educational entertainment and have won more than 1,200 industry educational and parenting awards.



We have a very valuable brand of parent trust and a propriety scope and sequence built by learning experts over our 18-year history that covers more than 2,600 skills. Our scope and sequence includes a number of the critical learning methods and skills, recently validated at some of the best teaching schools across the world. Our ability to quickly incorporate these breakthroughs into our content is a major differentiator and a competitive advantage for LeapFrog.

To date we have more than 13 million parents connected to our ecosystem and we have the best team in the business that's dedicated every day to making life-changing learning solutions for children.

As we head toward the holiday season, I believe that we're better positioned for success than we were in 2012.

All of our new tablet introductions for holiday 2013 are stronger. Consumers in the US this year all have a choice at retail of eight unique LeapPad SKUs at four different price points starting at an entry price of \$79 to the ultimate children's learning tablet at \$149. At \$79, \$99, \$129 and \$149 LeapPad2, LeapPad2 Power, LeapPad2 Licensed Bundles and LeapPad Ultra provide a compelling selection of awesome kids' learning tablets at a variety of prices to fit every family's budget this holiday.

All of these tablets work with LeapFrog's unique world-class library of more than 800 life-changing content experiences. Our LeapFrog library gives parents a safe and easy way to find top quality eBooks, games, apps, videos and music for their children, all designed or approved by our highly experienced team of learning experts.

Presales of our new LeapPad Ultra are strong selling out at leapfrog.com in a matter of days. And the LeapPad Ultra is still available on pre-sell on a few online stores right now and will be available on store shelves later this month.

On the international front, the LeapPad Ultra has already been named one of the top ten holiday items for 2013 by three major UK retailers, Hamleys, The Entertainer and Argos. In addition, the recent launch of LeapPad2 in France is a big success and we're expecting significant growth over last year's LeapPad1 sales.

Early sales reads indicate that on our new LeapReader, Learn to Read and Write platform is a significant step up from its predecessor the Tag. Pre-sales orders of LeapReader exceeded our expectations globally and initial point-of-sale results have been very encouraging. With the transition to new fall planograms LeapReader will be widely available on retail shelves in the coming weeks.

With the new Reading and Writing titles and fresh 3D books available and the launch of our new LeapReader download store in late July, which has additional audio eBooks, LeapReader is poised for a very strong performance this fall.

Sales of our handheld learning gaming system, LeapsterGS, are growing significantly. The \$10 price drop from \$69 to \$59 on LeapsterGS has had a very positive impact on retail sales and extended our market share lead in this category, reaffirming that we have the best handheld learning gaming system in the business that's even better at \$59.

We have some great new additions to our learning toy line. We showcased a new Read-With-Me Scout and Violet and Learn-to-Write with Mr. Pencil app toy at our New York media event in June. The response to these new reading and writing skill building toys was unanimously positive. They just start today at the shelves and early sales numbers are looking good.

Retail partner space and promotion commitments for holiday 2013 are greater than last year. Our major retail partners around the world are excited about the quality and quantity of our new introductions for this holiday season. As a result, we have commitments for greater space and stronger promotion support for holiday 2013 from many of them.

Our supply chain is improving. The terrific sales growth over the last couple years put a significant amount of pressure on our supply chain. Our ability to meet this higher demand, while also shipping our new platforms earlier then ever before, are clear examples that our focus and improvements in operational efficiency in this area are paying off.



Our new improved supply chain helped drive our sales growth in quarter two and will give us the opportunity for earlier sales reads and are leveraged to more effectively meet consumer demand in the holiday season. While we're very encouraged by the early results of our 2013 product launches and commitments for greater retail partner support, we realize it's still very early in the year.

Holiday sales are significant portion of our whole business and there are few shopping days this year between Thanksgiving and Christmas and no indications that the challenges facing the economy and our industry will lessen any time soon.

There's no question that we'll face even greater tablet competition this holiday season, although none of those competitors have a vast curated content library of children's content like we have and remember the number one things parents are looking for when selecting a learning tablet for a young child is the guality and quantity of safe, fun, educational content available.

Our results for the year will ultimately depend upon the strength of the consumer environment and sales of our learning solutions during the important holiday season. We believe that we have our strongest product and content portfolio, marketing campaigns and retail promotions ever, as we head into the holiday season.

While we're keenly focused on delivering results for this year, we're also making long-term investments in our business to drive future growth, investments in content, new business categories, line refreshments and extensions, international expansion, online communities and internal updating systems. I spoke about these investments at length on our last earnings call.

Since our last call, we hired Ken Adams, our new Senior Vice President of Sales, who joins us after having a very successful 28-year career at Hasbro. I have known Ken for over 15 years and I can tell you he's widely respected as one of the top sales executives in the industry and has a proven record in developing top sales teams and deploying highly effective growth strategies. We're incredibly excited to have Ken on our team.

So in summary, we're off to a great start and making really good progress in our 2013 business plans. We delivered solid first half financial results, launched our 2013 product line, continued to receive prestigious awards and have good sales momentum going into the holiday season.

We've made good progress against our beginning of the year annual guidance, which have achieved probably the third year running that we will deliver strong top and bottom line growth and we're probably one of the few Companies in the industry with consistent year-on-year growth.

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 with an incredible commitment and passion in delivering pure, learning fun across the globe that helps children achieve their potential. I'm very proud of the progress we've achieved together.

Now I'll return the call -- turn the call to Ray Arthur, LeapFrog's CFO, who will talk more about our Q2 performance and 2013 outlook in more detail.

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

Thank you, John, and good afternoon, everyone. Our second quarter performance was solid and exceeded our expectation. The results highlight the growing demand for our industry-leading educational entertainment products and validate the tremendous potential of LeapFrog brand. We're happy with the continued momentum and we enter the back half of the year in strong financial shape with a number of exciting new product launches.

Worldwide net sales for the quarter were \$83 million, up 16% compared to last year's \$71 million in sales. The impact on net sales from changes in currency exchange rates was immaterial.

During the quarter due to improved supply chain efficiencies we were also able to ship over \$4 million in new product that we had originally planned for the third quarter in order to satisfy retailer demands.



Net sales for our US segment were \$58 million, up 19% compared to the \$49 million reported a year ago. Net sales growth in the US segment was largely driven by increased sales of learning tablets and Learn-to-Read platforms including the recently launched LeapPad Ultra, LeapPad2 Power and LeapReader reading and writing system.

In our international segment net sales were \$25 million, up 10% compared to the \$22 million reported a year ago. Changes in currency exchange rates had a 1% negative impact on net sales in the current quarter. Our sales growth was largely driven by increased sales of learning tablets and learn-to-read platforms.

Let me now turn to results by business line. Worldwide net sales of multimedia learning platforms in content, which includes learning platforms, content and accessories, increased 20% year-over-year. Our learning tablet and learn-to-read business each had double-digit net sales growth. Additionally, within our multimedia learning business we delivered net sales growth in each of hardware, content and accessories.

Sales of LeapPad hardware were particularly strong and more than offset expected declines in older platforms that we're transitioning out of, such as LeapPad1, which is our first generation LeapPad platform, Leapster2 and Leapster Explorer that has been replaced by LeapsterGS and Tag a five-year old learn-to-read system that has been replaced by LeapReader, our new learn-to-read and write system launched in the second quarter.

As to learning toys, net sales increased 13% driven by sales of our new Read With Me Scout and Violet line and Learn to Write with Mr. Pencil app toy.

Gross profit for the quarter was \$31 million, an increase of 8% compared to the \$29 million reported for the prior year. Gross margin rate was 37.2%, down 270 basis points year-over-year. Gross margin rate declined due to mix as hardware increased as a percentage of sales giving new platform launches for LeapPad Ultra, LeapPad2 Power and LeapReader. This decline was partially offset by higher sales volume resulting in better leverage of fixed costs.

Operating expenses for the quarter were \$36 million, flat compared to the \$36 million reported a year ago and are down 720 basis points as a percentage of sales.

SG&A increased 8%, primarily due to an increase in headcount to pursue our strategic priorities but declined as a percentage of sales by 200 basis points.

R&D expenses were relatively flat decreasing 2% due primarily to timing of development projects.

Advertising including our marketing and retail programs decreased about \$2 million or 38% year-over-year as we shifted some spending to the second half of the year. In addition, Easter occurred in the first quarter of 2013 compared to the second quarter of 2012 shifting some of our advertising dollars into Q1. We expect our advertising to sales ratio to be flat for the year compared to prior year.

Net loss for the quarter was \$3 million, an improvement of \$5 million over the \$8 million loss reported for the prior year.

Net loss for paid basic and diluted share was \$0.05, an improvement of \$0.07 compared to the \$0.12 loss per share a year ago.

Normalized net loss per basic and diluted share was \$0.04, an improvement of \$0.03 year-over-year. Normalized earnings have been adjusted to reflect an effective 37.5% tax rate and in the second quarter of 2013 normalized net loss per share was better than GAAP net loss per share by one penny primarily due to certain discrete tax expenses.

Adjusted EBITDA, which is EBITDA adjusted for stock-based compensation and other income and expense, was \$2.6 million, an improvement of \$3.3 million year-over-year and the first positive EBITDA the Company has seen the second quarter since the Company went public.

Now let me turn to the balance sheet. Cash and equivalents finished at \$181 million, an increase of \$54 million or 43% compared to a year ago. Our accounts receivable balance was \$62 million, an increase of \$11 million compared to a year ago due to higher sales occurring later in the quarter



compared to prior year. Our portfolio is in good shape and our DSO is relatively flat the last year at 67 days compared to an actual 65 days a year ago.

Our inventory balance was \$67 million, up \$14 million or 26% compared to a year ago due improved supply chain efficiencies, which allowed us to get new product to market faster. Our inventory consists of top quality products and overall we believe both LeapFrog and retail channel inventories are at appropriate levels to meet consumer demands.

Deferred taxes increased \$24 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 maintained approximately \$70 million in valuation allowances against our deferred tax assets that in essence are not on our balance sheet.

Accounts payable is up \$13 million related to the planned increase in inventory as we prepare for the holiday season and additionally accounts payable is up as we received more inventory later in the quarter than we did last year.

In summary, our balance sheet is in excellent shape. Also worth mentioning is that Mollusk Holdings, which is controlled by Larry Ellison has completed the sale of their position in LeapFrog common stock and accordingly is no longer selling shares under their 10B51 plan.

I'll finish our prepared remarks with our outlook. We expect net sales in the third quarter to increase from mid to high single-digit growth rate compared to the third quarter of 2012. We expect third quarter gross margin to increase in dollar terms year-on-year and gross margin rate to improve from our second quarter rate but this rate will still come in below the prior year given our projected shipments of new hardware platforms and increased duties as a result of Congress not as of yet renewing a duty reduction on educational tablets and reading systems, which Congress has done in each of the past 12 years.

We also expect an increase in operating expenses year-over-year due to higher headcount supporting our strategic investments in the future. This growth rate is expected to be in line with our net sales growth for the quarter. As a result, we expect third quarter GAAP and normalized net income per diluted share to be flat to normalized net income per diluted share in the third quarter of 2012, which was \$0.32.

This compares to GAAP net income per diluted share of \$0.62 in the third quarter of 2012, which included substantial non-recurring tax benefits due to expired statutes of limitations.

For the full 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.

Much of these investments will begin to impact operating costs in the third and more so in the fourth quarter of 2013. We expect operating income improvement to be driven largely by net sales growth. We are also 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 adjustment related to our evaluation allowances.

These amounts also include the impact of an approximate 3% increase in fully diluted common shares from year-end 2012 due to more in the money options and the vesting and the exercise of restricted stock units and stock options respectively.

This guidance compares to GAAP and normalized net income per diluted share for 2012 of \$1.24 and \$0.56 respectively.

While we did slightly exceed our expectations in the first half of the year, we are not raising our full-year 2013 guidance. Our [full] year sales are highly dependent upon the consumer environment during important holiday season.



There's still much of the year ahead of us and the current consumer environment continues to be very challenging. In addition, as we have consistently messaged, we are investing in our business in 2013 and this investment will impact operating costs in the third and more so in the fourth quarter of 2013.

As we look to full year of 2013 and years both 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 product launches 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

(Operator Instructions). And your first question comes from the line of Scott Hamann at Keybanc Capital Markets.

#### Scott Hamann - Keybanc Capital Mkts - Analyst

Just in terms of the gross margin, a question on the kind of the magnitude of the shortfall versus last year was driven by mix versus potentially that the learning tablet duty thing and how you're thinking about that for the balance of the year because it seems to me like the LeapReader, at least historically under the Tag platform, has been a higher margin product and just trying to understand that dynamic a little bit.

# Ray Arthur - LeapFrog Enterprises, Inc. - CFO

The duty issue is probably about \$1.5 million annual issue to \$2 million, so it's not the major driver here. The major driver is just selling in so much hardware, which runs at a lower margin base than content and accessories and ultimately as the platforms are sold through the follow on content will be sold, so we don't expect this to be a permanent situation. It's more Q2, Q3 with hopefully seeing margin rates start to tick up in Q4 with more content sales.

### Scott Hamann - Keybanc Capital Mkts - Analyst

Okay and then just a follow-up on the guidance and I think you kind of hit on the fact that you said the first half was above your expectations and you didn't raise the guidance. Is the variability really tied to the sales portion of it or do you have some optionality on marketing spend or some other stuff that's kind of long for the rest of the PL?

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

Realistically we're only about 25% through our sales year so raising guidance for the balance of the year based on that very small amount of the year being done just didn't seem prudent to us. In addition, we are investing in the business this year in terms of a number of different initiatives that will impact us in operating expenses later in the year so we believe that it is prudent at this point to maintain our guidance, which we've said is mid to high single-digit sales growth and maintaining constant operating margin with that of last year.



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

And let's not forget there are fewer shopping days between Thanksgiving and Christmas that traditionally gives a lot of (inaudible) ding to the business and there's nothing we've seen on the horizon at the moment that is going to reduce the economic headwinds that we've been facing this year and the rest of the industry has been facing too.

Scott Hamann - Keybanc Capital Mkts - Analyst

Fair enough, thanks a lot.

# Operator

John Taylor, Arcadia.

# John Taylor - Arcadia Investment Corp. - Analyst

I've got a couple of questions if I may. The spending you're doing to -- strategic spending you're doing that's coming out of the P&L this year, I wonder if you could give us a sense of when you start to see return on that. Is it most likely to happen in the first half of next year? Is that something that's more likely to happen in the second half of next year?

# John Barbour - LeapFrog Enterprises, Inc. - CEO

I think you're going to see it happening more in the second half of next year. I mean first half is only about round numbers, 25% of our business so I don't see it having a dramatic impact. You know, our business is so seasonal that will have impact on the second half of next year and basically following the next couple years beyond that will as well for some of the more longer-term things we're working on.

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

JT, some of that stuff is systems that we'll be working on into 2014.

John Taylor - Arcadia Investment Corp. - Analyst

Okay so there will be some spill over then in the first half of next year as well.

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

Yes we have a business, as you know, that lost money for a good many years and only in the last couple of years has started to really turn around and turn around fairly explosively, so now there's a bunch of systems that we haven't really invested much in over the years that need some work and so we're investing in that. We're investing in product. We're investing in international. We're fortunate we're focused on the children's education. It's a [turn up] market we feel has a lot of growth ahead of it and that's going to take some investment.

#### John Taylor - Arcadia Investment Corp. - Analyst

Okay and then the -- you said I think you had about \$4 million of early arrivals that you were able to get out the door. Was all of that pretty much in the US or did some of that get split within or aftermarket?



# John Barbour - LeapFrog Enterprises, Inc. - CEO

I think the bulk of it was the US. The advantage we had was that we managed to get product a little bit earlier than we thought because of some of the operational improvements we made in supply chain and starting to work in product a little bit earlier. It gave us some opportunities to do some early on shelf promotions with some retail partners. So it was a fortuitous opportunity.

#### John Taylor - Arcadia Investment Corp. - Analyst

Okay and then you also mentioned that your inventories are up so because of on the supply side I guess, so and they were up significantly more than sales were up so does this set you up for an opportunity to maybe get an extra turn or half a turn in the second half of the year simply because you have stuff on hand now?

# John Barbour - LeapFrog Enterprises, Inc. - CEO

I'm not sure it will do that but I think it will certainly give us a better read. So you know, the sooner we can get new product into the marketplace the quicker we can get a read on it and the quicker we can go start chasing inventory. I mean the challenge we do have with a bunch of our platforms systems, is the lead times for manufacture component purchase and then shipping limits our flexibility every day now as we head toward the holiday season. So the earlier read we get in new products the quicker we can potentially respond.

There will always be a limit to that response but the quicker we can respond JT, really depends upon what happens over the next four to six weeks in the sales of those products and against what we're projecting for the year.

#### John Taylor - Arcadia Investment Corp. - Analyst

Okay great, thank you.

#### Operator

Michael Swartz, Suntrust.

# Michael Swartz - Suntrust Robinson Humphrey - Analyst

Just wanted to ask a question on the commentary about the double-digit sales growth, I mean was that all commentary about wholesale growth or did that also include retail sell through as well?

# Ray Arthur - LeapFrog Enterprises, Inc. - CFO

Are you talking about does it include our customer sales to (multiple speakers)?

#### Michael Swartz - Suntrust Robinson Humphrey - Analyst

Yes where you were speaking around customer sales versus your wholesale shipments.



Ray Arthur - LeapFrog Enterprises, Inc. - CFO

No we're talking about our sales shipments into the channel.

John Barbour - LeapFrog Enterprises, Inc. - CEO

Yes.

Michael Swartz - Suntrust Robinson Humphrey - Analyst

Okay and did you have any color that you could provide us on how retail did during the quarter?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

Yes, I think that for the year we're seeing it but if you take away our discontinued products basically a flat kind of POS.

Michael Swartz - Suntrust Robinson Humphrey - Analyst

Okay great and then with just a follow-up on gross margin, I know in the first quarter you had talked about some quality issues that may have impacted that. Did you see that continue into the second quarter? You didn't specifically call it out and either way. Either way did you kind of get to the bottom of that?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

We did not see that continue into Q2 at this point and we continue to monitor.

John Barbour - LeapFrog Enterprises, Inc. - CEO

Well, they weren't really quality issues. They were return issues.

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

Defective.

John Barbour - LeapFrog Enterprises, Inc. - CEO

Defective. And I mean defective doesn't mean there's a quality issue. There's lots of different reasons why consumers at will return product to retail so I wouldn't define it as a quality issue. It might be not taken but that's not how I would define it.

Michael Swartz - Suntrust Robinson Humphrey - Analyst

Okay helpful, thank you.



#### Operator

Lee Giordano, Imperial Capital.

#### Lee Giordano - Imperial Capital, LLC - Analyst

Can you talk a little more about the competitive environment for kids tablets this upcoming holiday versus last year and how you think you're positioned? Thanks.

# John Barbour - LeapFrog Enterprises, Inc. - CEO

Yes, there's no question that every year we face new competitors and new systems. Some are existing competitors and that's why we're constantly focused and trying to create a better mousetrap than everybody else. But the thing I would continue to step back on is that everything we see and comments that we get from people is that the availability of safe, proven content, educational content for kids, is a key part of that decision process and nobody in the marketplace has the curative library of our size. At the end of this year we'll have over 800 pieces of educator either developed or approved content on our platform.'

And there's no one in the market who can even get close to that so we believe that the selection of tablets that we've got in the marketplace along with a variety of price points and more importantly this market leading content library stands us in good stead versus the competition so there's no question we'll be competitive but we believe that we've got the right strategies in place to continue to grow our business.

#### Lee Giordano - Imperial Capital, LLC - Analyst

Got it and on the international front, are there any countries you'll be in this holiday that you weren't in last year? And then what's the next new region that you'll be entering?

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

There's no significant countries that we'll be in this year versus last year. I mean were very excited about our business in France. It was a bit of a test business for us when we launched LeapPad one there last year with their French software. It was success last year and our team over there is doing a wonderful job and going to show some significant growth this year, so we're excited about what's happening there and, to be frank, our business across international. Chris Spalding, who runs our international business, has done a wonderful job for us for a number of years and continually drives this business up and it's great to see.

Regarding new markets, we're looking at a bunch of markets. Chris and I, have visited a bunch of new markets. We talked to a whole bunch of partners. We've run some models. We've talked to experts. We've visited schools and we're looking at a number of markets at the moment but haven't defined yet which, if any, markets will go to attack and what time line we're going to do it in.

Lee Giordano - Imperial Capital, LLC - Analyst

Great thank you.

# Operator

Sean McGowan, Needham & Company.



Sean McGowan - Needham & Company - Analyst

Couple of questions from me as well; one, Ray, could you comment a bit if you can on the year-over-year comparison in gross margin in the international segment? Was that similar delta as the overall gross margin?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

International is actually somewhat better but you've got to understand that we don't allocate all our costs to international so had we allocated more of our cost to their improvement probably would have been aligned with the US. Yes and they also didn't get the same burst of new product launching at the end of the guarter because their partners just couldn't respond as quick as the ones we had in the States.

Sean McGowan - Needham & Company - Analyst

So was the gross margin internationally up versus a year ago in the second quarter?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

We don't generally go into that.

Sean McGowan - Needham & Company - Analyst

Okay on that beauty issue, is that something that could be reversed between now and the end of the year or is it a foregone conclusion that you'll have that expense?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

We're hopeful and we're not sure about this but we, as well as other companies that are affected by the potential legislation that's out there, are trying to encourage the Congress to take up the bill to adopt it and to make it retroactive, which they've done in previous years. It's just that they're taking up later this year than they have in prior years. So we still have the opportunity that could come out favorably in our direction.

Sean McGowan - Needham & Company - Analyst

Okay but the assumption baked into your guidance is that it won't happen?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

Yes and, Sean, I'm sorry that international margin is up year-on-year.

Sean McGowan - Needham & Company - Analyst

Oh okay thanks, appreciate that. Now, on the issue of the early shipments, I want to tag onto JT's question and he was asking about could you get another turn in there but let me ask it this way. If your better systems and better being setup are able to pull sales that put sales on the second quarter that might have come in the third, might you also get sales in the third quarter that might otherwise have waited till the fourth?



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

I mean that's possible. I wouldn't describe it as pulling sales. The retailers wanted this stuff. There have been strong retail demand for getting LeapPads in stock in previous years. We've always had limited supply and coming in late so retailers just have an appetite for getting the product in as soon as possible, getting their planagram set. Is there a possibility that some in Q4 could come into Q3? I'd say yes.

John Barbour - LeapFrog Enterprises, Inc. - CEO

Yes but, Sean, the thing about it though is what you need to remember is that it's limited by the fact that of availability to get product.

Sean McGowan - Needham & Company - Analyst

Right.

# Ray Arthur - LeapFrog Enterprises, Inc. - CFO

It's actually limited by two things, demand and getting product so there certainly is a potential to get increased sales because of the way that we're planning our inventory and it will be interesting to see.

#### Sean McGowan - Needham & Company - Analyst

Okay so you get an app then and your guidance for the third quarter, as well as the full-year, just some basic math implies the potential for the fourth quarter to be down. Are you trying to make your statement there or just trying to be conservative?

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

You know we plan conservatively. We're only 20 some odd percent into our year and it's a challenging environment out there today. You know, you've seen Toys-R-Us and other retailers out there reporting POS declines. We've been fortunate to be doing better than that but it just doesn't seem prudent at this time to go out and increase sales estimates when we gave estimates to beginning of the year and we still believe they're valid. Look we think we'll finish the year with mid to high single-digit sales and we'll hit those offering earnings numbers.

Sean McGowan - Needham & Company - Analyst

Okay thank you very much. Good luck.

#### Operator

Stephanie Wissink, Piper Jaffray.

### Stephanie Wissink - Piper Jaffray - Analyst

John, just one question for you so I can follow-up to some of the questions around inventory but I am curious around your supply chain efficiency efforts that you've -- it sounds like you've actually achieved most of the efficiency there. How does that position you in the holiday with your (inaudible) whose assigned to in season demand? How should we think about that?



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

No I think one of the key things to -- for all of us to remember is that when you build in the time to ship these platforms into the sets, the time it takes to manufacture them and the time that we've got to actually order our screens and chips etcetera, our flexibility for ordering inventory on platforms is fairly limited in terms of growth in the fourth quarter. We've just seen the significant write offs that Microsoft has made for slightly missing their surface number and that's something that we've got to be concerned about as a smaller company.

So I would say as we're running our business, everything we can do to enhance our supply chain is incredibly important and each of those things gives us another opportunity to run our business more effectively. But when it comes to the fourth quarter and it comes to the platforms, we're calling numbers now, you know, two, probably a month ago as to what we think we're going to do this year. We're building flexibility into it and the better efficiency we've got the chances are it does give us a little bit of flexibility. That flexibility is still pretty limited for the fourth quarter.

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

Because there are long lead things.

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

You know, when you think of it, we're ordering screens for 10 weeks before they go into production. Then they go into production, then we've got shipping coming across so I just -- I think it's important in terms of people's understanding of flexibility. Operational efficiency does give you some benefits but if you're getting your reach in these products only 12, 14 weeks before Christmas, if that, it's very tough to make dramatic changes in availability of product.

# Stephanie Wissink - Piper Jaffray - Analyst

Okay fair enough. And then maybe just a follow-up to that on the component side. So you've talked about competition in the tablet category. Can you talk about some of the demands versus supply with some of those key components, particularly related to your [LeapPad Ultra]?

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

Yes we've not seen and we've not had any issues at the moment in terms of availability or component shortages at this time. And so from that standpoint it's really just trying to manage the lead times to the perfectly frank, as I say. If any of the systems or the piece of paper it calculates how many weeks this process actually takes from us ordering the components to getting the product on shelves, you'll see that the time line's pretty long there. So flexibility in the fourth quarter traditionally we've managed to flex a little bit in the fourth quarter but, as everybody knows, we rob the first quarter of inventory at that time by driving massive process accelerated programs through there but unfortunately it was just potentially moving sales at that time from the first into the fourth quarter. So at the moment we're not seeing any issues, knock on wood, in terms of the componentry and really it's just down to our appetite for risk in terms of ordering up front.

### Stephanie Wissink - Piper Jaffray - Analyst

Okay then, Ray, if I could just a couple for you; the advertising spend, as I look at the model over the last five years or so, has come down quite significantly. If you could just talk about that line item in particular how you're thinking about that as a percentage of sales, that would be helpful. And then I think you made some prepared comments around the share count. If you could just give us those comments again, how we could -- you're thinking about the dilution companies, (inaudible) [initiatives], that would be very helpful. Thank you.



# John Barbour - LeapFrog Enterprises, Inc. - CEO

Let me cover advertising because in the advertising segment what you're seeing here is a couple of big things happening. We're seeing a shift in our advertising from traditional TV advertising into digital advertising and, as we start to leverage our 13 million connected parents as we go forward. So, as we look at what we're doing, we're driving greater efficiencies across the model that we have as we drive our business going forward and that's what you're seeing over a multiyear basis in our business.

So you're seeing a small shift from traditional TV into digital but you're seeing a greater efficiency coming from communicating directly to our existing customer base. So moving to more of a sniper approach than a throw everything against the wall approach of TV. TV is still incredibly important to our business and we're constantly watching it.

The other thing you'll see as a shift this year in advertising because we did some [terse] TV advertising just before summer last year to see whether it was cost effective. It wasn't. We're moving those dollars to later in the year this year, where we feel a bit more effective.

# Ray Arthur - LeapFrog Enterprises, Inc. - CFO

The other thing I would say for your modeling purposes we're still planning on advertising being about 7% of sales, which is consistent with prior year. As to share count, clearly there are, as the share price goes up, the trading price, more options fall into the in the money category and start to fall into the calculation of EPS. Secondly there are continued vesting of RSUs that have been granted over the years as well as all stock option exercises. What we have seen is we've had about 69 million fully diluted shares last year and what I think we're going to end up with is around 72 probably this year. It's about a 3% increase.

#### Stephanie Wissink - Piper Jaffray - Analyst

And how about some for next year? How should we think about that? The same type of increase year-on-year?

# John Barbour - LeapFrog Enterprises, Inc. - CEO

No I don't think so because a lot of the options that were out there were way under the water because the stock price was trading down so there was a big increase due to the stock pricing going from a couple of year ago being at three bucks or four bucks, you know, up to around 10. Then you had an increment up to 12 so I think there will be some impact. I haven't projected it yet. I don't think it's going to be that magnitude though.

### Stephanie Wissink - Piper Jaffray - Analyst

Okay thank you.

### Operator

Dave King, Roth Capital.

# Dave King - Roth Capital Partners LLC - Analyst

I guess first off kind of just following up on some of the other questions, maybe spinning the supply chain question operational efficiency in (inaudible) another way. I guess it would be knowing that you don't really want to the abject risk of ordering up front and knowing that you don't have much upside to that and the point 12 to 14 weeks of visibility. I guess to what extent now do you exposed to risk of having too much inventory in the channel? Do you see that as something that you guys are exposed to in any way yet or not? Maybe you can just provide some color there.



# John Barbour - LeapFrog Enterprises, Inc. - CEO

I think for those of you who have been on for the last 2.5 years since I've been here, you'll know that I try to manage things very tightly and we tend to manage things very tightly. Even if it means leaving a little bit of business in the table. All I can say to you right now is we continue to manage things very tightly. As we look at our inventories right now, we're in a good spot. We're actually better prepared for this holiday season. Than we have been before and we're feeling good about where inventory sits at the moment and the plans we have for the holiday season.

# Dave King - Roth Capital Partners LLC - Analyst

Fair enough. Then maybe switching gears to the guidance questions a little bit, I mean I fully appreciate that only 25% of the business has already been done at this point and the holiday I think there's a question you kind of answered on that at this point. But maybe as you think about the third quarter, mid to high single-digit versus the stuff, the strong double-digit gains you've already had, it (inaudible) are a little bit down from I guess the guidance a little bit slower than what you've even guided to in recent quarters. Maybe you can help us understand or reconcile that, particularly as we think about some of the traction you've had with new products whether it's Leap Reader, what we thought of Ultra earlier this week and then maybe you could even touch on LeapPad Two power and how that's been going at this point.

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

We gave guidance in the beginning of the year. We've been pretty clear. In fact we've been very focused on it. We're a little bit ahead of the game at the moment if you take the \$4 million of hardware that's shifted a little bit, as we had got early shipment potentially from the second to third to second quarter, the fact is we're still on plan to do that. That's where we are right now. We're going to continue to focus on that and try and deliver. If we over deliver I promise you will be happy but right now that's our guidance. It was the guidance we put on the table and that's the guidance we're sticking with for the year.

Secondly regarding the selling of new products, it's very early days and we're very excited by the products. But you know what, we're sitting here in the middle of summer and the numbers that we're seeing aren't going to change the world. They just give us a really good read of how we feel about going things forward. We still have a long way to go. I think anyone who is looking at that guidance right now with 25% into it and seeing bigger things in it, I would suggest that you hold your powder at the moment until we see how the third quarter goes.

# Dave King - Roth Capital Partners LLC - Analyst

Fair enough and we definitely appreciate the conservatism I guess. And then maybe one last question then for Ray. Any update on the valuation allowance against the DTA and when you might expect to recover that, if it's still this year.

Well, I think that we'll continue to monitor our operations and when we get to the point where we feel pretty certain about our results for this year, projected results for this year, that will address that amount. That could be as early as Q3. It could be in Q4 but if we make the assumption that we hit our plan, it's going to be some time this year in Q3 or Q4.

Dave King - Roth Capital Partners LLC - Analyst

Okay fantastic, thank you.

#### Operator

Gerrick Johnson, BMO Capital Markets.



# Gerrick Johnson - BMO Capital Markets-US - Analyst

Ray, you said earlier that POS in the quarter was flat excluding discontinued items. Are you kind of short changing yourself there because of LeapPad one, TAG, they're still there for the entire half of the year and the new stuff is barely on the shelf? Can you tell us what POS was if you did include those discontinued items?

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

Those items were included in the number. We don't consider them discontinued.

Those things at Leapster Three, Leapster Two, sorry, the original stuff that was where you actually started to get it off last year, which there were some early sale on the beginning of last year.

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

What I would say is that since these new products have been introduced, we're starting to see improvement in POS, which is encouraging.

# Gerrick Johnson - BMO Capital Markets-US - Analyst

Okay thanks and a couple days ago you put out a press release indicating that the Ultra had sold out on preorder on LeapFrog.com. How many units do you allocate to presale on LeapFrog.com?

# John Barbour - LeapFrog Enterprises, Inc. - CEO

As you could probably guess, that would something our competitors would love to know, Gerrick, so, we prefer not to disclose that.

### Gerrick Johnson - BMO Capital Markets-US - Analyst

Okay thanks.

#### Operator

Edward Woo, Ascendiant Capital.

### Edward Woo - Ascendiant Capital Markets - Analyst

Is the LeapPad Ultra and the LeapPad two power, is that going to be rolled out in the English speaking markets this year? And where will it be? Technically the Ultra in the retail store and will it be with the rest of your LeapFrog products or will it be, you know, the Electronics category?

# John Barbour - LeapFrog Enterprises, Inc. - CEO

And the first question is is that LeapPad Ultra and LeapPad Two Power get into all of our major markets and secondly we're really excited about having eight LeapPad SKUs altogether within the Leap products section in store with price lines going from \$79 up to \$149. We feel that we've covered an incredible gamut of opportunity there for parents of all incomes to be able to get into this brand and deliver a great educational experience for their kids. So we're exactly where we're going to stay in store and we feel really excited about the line that's there and when you



add the GS at \$59 now, you know, we feel we've got a pretty unbeatable spread here of market leading products with the best onsite library in the space.

#### Edward Woo - Ascendiant Capital Markets - Analyst

Great and the other question I had was you mentioned that your gross margin was effective based on the higher allocation of hardware. Was there any impact on the lowering of the LeapPad Two from \$100 or \$99 to \$79 and also the it's built in as I guess the PowerPad effectively with the price of \$140 to \$100?

John Barbour - LeapFrog Enterprises, Inc. - CEO

Well, can you run that again, sorry?

### **Edward Woo** - Ascendiant Capital Markets - Analyst

Sure, sure. You mentioned that gross margin was negatively affected because of a higher mix of hardware sales in the quarter. I was wondering if there's any impact in the quarter at all from the reduction of the LeapPad Two retail price from \$99 to \$79.

# John Barbour - LeapFrog Enterprises, Inc. - CEO

No, no none That wasn't really the impact. It was more an impact of mix of shipping more hardware than we than we did last year as a mix against content.

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

And accessories.

**Edward Woo** - Ascendiant Capital Markets - Analyst

Great. Well, thank you.

#### Operator

And your last guestion comes from the line of Drew Crum at Stifel.

# **Drew Crum** - Stifel Nicolaus & Company, Inc. - Analyst

So [TD] talked about retail commitments being up on the whole. Can you talk about your retail commitments for your tablet devices specifically? And then also you talked about the experience you had in the quarter with the Leapster GS cutting price. How did that impact profits and are you more apt to get flexible or creative pricing given the range of price points you have on the tablet devices now? Thanks.

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

Yes. I mean, look, I will just talk the GS Plus. With the GS in year two we had some component reductions that allowed us to bring our price down. I can't say exactly I think we're making the same or slightly less on the GS but I don't think they had a dramatic impact on marginality. And regarding



retail commitments in tablets we're super excited about the response that the retailers have given to our products. I was in all of the meetings where we showed our new tablet line to all of our major partners and I've had the chance to see both their space commitments and their promotional commitments, certainly the ones in the States. The UK is pretty similar in that side and as we sit and we model the business and model the support, we feel that we've got a higher level of support than we had last year.

Now, it's important to say within those stores the likelihood is they're going to have more tablets in their stores as well so we're going to have more competition so it's not just a one sided street. I think we've got the best selection, best range in the business and we've got better support but there will be more competition in the stores as well.

**Drew Crum** - Stifel Nicolaus & Company, Inc. - Analyst

Okay.

#### Operator

At this time I'd like to turn the call back over to Karen.

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

Great. Well, thank you, everyone, for joining us in our call today and please feel free to call Ray or me with any follow-up questions. Thanks and goodbye.

#### Operator

This concludes today's conference call. You may now disconnect.

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