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LF - Q3 2013 LeapFrog Enterprises, Inc. Earnings Conference Call

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OVERVIEW:

LF reported 3Q13 worldwide sales of \$201.3m, GAAP net income of \$26m or \$0.37 per diluted share. Expects full-year 2013 net sales to be \$570-590m and normalized net income per diluted share to be \$0.36-0.46.



CORPORATE PARTICIPANTS

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

John Barbour *LeapFrog Enterprises, Inc. - CEO*

Ray Arthur *LeapFrog Enterprises, Inc. - CFO*

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PRESENTATION

Operator

Good afternoon. My name is Rachel and I will be your conference operator today. At this time, I would like to welcome everyone to the LeapFrog Q3 2013 earnings conference call. (Operator Instructions). Thank you.

I would now like to turn the call over to Karen Sansot, Senior Director of Investor Relations. Ma'am, you may begin your conference.

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

Thank you. Good afternoon, and welcome to the LeapFrog Enterprises conference call to review our results for the third quarter ended September 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 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, November 25, and will last until we announce our fourth-quarter results, which we expect to announce in early February.

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 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 statement are described in our most recent Form 10-K filed with the SEC. LeapFrog makes these statements as of today, November 4, 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. Good afternoon. We had a strong third quarter, delivering a solid 4% net sales gain in a very difficult retail and economic environment, increasing our operating income by 16% and growing our EBITDA by 14%. We head into the holiday season with our best lineup of children's educational entertainment ever, with hundreds of new pieces of content; LeapPads at four different price points from under \$80 to \$150, including our terrific new 7-inch LeapPad Ultra, our first Internet-connected kid-safe device.

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

LeapPad Ultra has been named to many top holiday toy lists, and received prestigious awards such as the Oppenheim Toy Portfolio Platinum Award and the National Parenting Center's Fall Seal of Approval.

In recent research, 97% of teachers surveyed said they would recommend LeapPad Ultra and its incredible library of fun and educational games and interactive apps to parents. This year we also introduced the LeapReader, a Learn to Read and Write platform that is a significant step up from its predecessor, the Tag. LeapReader offers a library of more than 150 learning experiences, including books, audiobooks, learn-to-read sets, flashcards, and discovery packs.

Reviews for the LeapReader have been exceptional. And in recent research, 98% of teachers surveyed said that they would recommend LeapReader to parents. LeapReader has also been named to some top holiday toy lists and received some prestigious awards, including a highly coveted Oppenheimer Award.

And our learning toy line has some exciting new additions, such as Read With Me Scout & Violet; the Learn to Write with Mr. Pencil Stylus and app; and the Creativity Camera protective case and app, as well.

Over the last 2 to 3 years, we have made good progress in the transformation of LeapFrog from an educational toy company into an educational entertainment company. And as we look ahead, we are excited and energized by a number of market opportunities that are likely to provide us with even greater opportunity for many years.

Let me touch upon three. Children's tablet growth -- tablets are now part of the daily life of tens of millions of children in the US and around the world, and the market has a lot of growth ahead of it. We plan to build on the successes we've achieved over the last two years and to continue to be the leader in the kid tablet segment of the market. According to NPD, more LeapPad kid tablets have been purchased lifetime to date by consumers in the US than nearly all of our kid tablet competitors combined. And more have been bought this year through the end of Q3 than any other manufacturer's kid tablets.

Personalized learning journeys -- we know children learn best when they're having fun and when the learning is at the optimum level for each child. We also know that every child is unique, and they all learn at different rates with different interests, yet much of the educational experience today is locked to a child's age or grade. Our technological and educational expertise now enable us to create personalized learning journeys for children, on a far larger scale than ever before possible. Millions of children that play today with our tablet and gaming systems are enjoying education that's being delivered at a personalized level across a variety of our content. It is this attention to detail that stands us apart from much of our competition.

Overseas growth -- the growing demand for quality educational experiences beyond school is not just a US, but English-language phenomena. Our international sales have grown at a greater pace than our US sales over the last few years. We are especially excited about the exceptional sales growth we have achieved in France over the last 12 months, with the launch of our French language LeapPads.

For all the success we've achieved, there is even greater opportunity in many markets that we do not currently sell in. We're excited about the future of LeapFrog and the opportunity ahead of the Company. We continue to invest significantly in our future product lines and have a lot of



product innovation in store for 2014. We will also be launching a new Learning Path in just a few days that will offer integrated digital experience, including an app for iPhones and iPads; a cool website; and an email blog that enables parents to get personalized learning ideas, share and discuss education topics, and track their child's progress.

We're operating in a growing market, and we have an exceptional team of employees with a vast experience in creating truly fun, engaging and compelling education experiences that help children achieve their potential.

Let me take a few minutes to talk about our financial performance for the first three quarters of 2013. We delivered net sales growth of 9% year on year, despite challenging economic and retail conditions, and on top of the 37% growth we achieved for the first nine months of 2012. We delivered double-digit growth in our multimedia learning business, while our toy business declined by a low-single-digit percent. Within our multimedia learning business, we delivered growth on hardware, content, and accessories.

Our net sales in the US for the first nine months increased by 7% year over year, and our net sales in international markets increased by 16%. International is an important component of our growth strategy, and is becoming a larger part of our business, now representing 28% of our net sales. All of our key international markets demonstrated growth year on year, but with international still less than 30% of our net sales, we have significant room to further grow internationally in the coming years.

Income from operations for the first nine months increased by 60%, and adjusted EBITDA increased 31%. We're entering the fourth quarter with our strongest third-quarter balance sheet in many years, with cash up 59% year on year, at \$78 million. And [enrytooth] are well positioned to support our fourth-quarter potential.

Let's now look to quarter four. As you know, quarter four results have a large impact on our full-year performance, and we're both optimistic and cautious heading into the important holiday season, for a variety of reasons. We're optimistic about our best product line ever, our concentration of advertising in the next several weeks, and the retail and marketing programs we have placed; while we're cautious about the overall economic environment, retail climate, the compressed holiday season in the US, and recent POS trends.

When we finalized our advertising and promotion plans for this year, we made the decision to move a significant amount of our promotional investment in the US later in the year to optimize the impact in the high-volume shopping weeks in November and December. Last year, sales of kid tablets increased over threefold from October to November, according to NPD's monthly sales data. This move should more effectively align our promotional investment with consumer demand.

As a result of this shift in timing of our marketing investment, a very tough retail environment, and increased tablet competition, our year-to-date POS was down year on year at the end of Q3. The bulk of our TV advertising investment in the US hits over the next six weeks. And we believe we are well positioned to drive retail POS in the fourth quarter as a result of our higher TV budget, plus increased trade ads and promotions.

2012 was an exceptional year for LeapFrog, with net sales growth of 28% for the year. We're up against a large POS comp in Q4, and as I said in our last call, we are facing greater children's and family tablet competition this holiday season. Although none of those competitors have a vast creative content library of children's learning content like we have, and our research shows the number one-things parents are looking for when selecting a learning tablet for a child is the quality and quantity of safe, fun, educational content available.

This significant increase in the number of competitive tablet introductions, along with a challenging holiday season, may result in a lot more price competition and clearance activity in the tablet category versus last year. With six fewer shopping days between Thanksgiving and Christmas, including two fewer weekend shopping days, we are facing a significantly compressed holiday season in the US. This shorter selling period between Thanksgiving and Christmas can result in a number of issues which could have a negative impact on our year.

Firstly, tighter retail inventory, based on slower year-on-year comps early in the season. Many retailers have shifted their toy book distribution dates, given Thanksgiving being one week later in the holiday season this year, thus slowing initial holiday sales trends. This could make what's already a highly conservative inventory environment even tighter.



Higher velocity in key selling days causing shelf out-of-stocks. Even if retailers have strong inventory in their pipeline, their ability to keep up on big sales days becomes harder as the season progresses. We have already started to see signs of this in our store checks. I personally store checked eight stores yesterday morning and found substantial out-of-stocks in our key items, despite stronger retail inventories than last year.

There are six fewer days this year to flow replenishment inventory to retail banner stores to respond to consumer demand. This compressed holiday season, retail nervousness, greater levels of competition, and year-to-date point-of-sale decline has led us to -- I think prudently -- revise our guidance downward for the year. Ray will cover the details in his part of the call.

In summary, I believe we've made good progress in our journey to transform LeapFrog into a global educational entertainment company, and we have lots of opportunities ahead of us. There's growing concern from parents around the world about the quality of education their young children are receiving, and a growing global demand for effective, early childhood development solutions. With our leading educational entertainment portfolio, proprietary scope and sequence, and exceptional team, we believe 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 1200 industry, educational, and parenting awards. We have a valuable brand that parents trust, and have more than 13 million connected to our ecosystem. 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 focused on expanding our business domestically and internationally, and investing for the long-term.

We have a team of professionals dedicated to strong execution in this critical fourth quarter, striving to deliver another successful year for all of our stakeholders.

Now I'll turn the call over to Ray Arthur, LeapFrog's CFO, who will talk about Q3 performance and 2013 outlook in more detail.

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

Thank you, John, and good afternoon. LeapFrog turned in a strong financial performance in Q3 2013. Despite the current economic climate that had declined in year-to-date retail POS, we still produced 1% sales growth in the US and 14% sales growth in our combined international markets for the quarter. We are well positioned for the holidays with our best product lineup, significant off-shelf promotions, and a strong marketing plan for Q4.

Now let me provide a bit more insight into our third-quarter financial performance, as summarized in the financial tables accompanying the press release. Worldwide sales for the quarter were \$201 million, up 4% compared to \$193 million a year ago, and were negatively impacted by 1% due to changes in foreign currency exchange rates.

The worldwide growth was largely driven by hardware sales, with the introduction of new products, including LeapPad Ultra, LeapPad2 Power, LeapPad2 holiday bundles, and LeapReader, a new Learn to Read and Write system. Net sales for our US segment were \$147 million, up 1% compared to year ago. And POS for our US segment was down in the quarter due to what we believe is a tough economic as well as competitive retail environment, and later timing of our preholiday advertising, which was planned to better align with customer shopping activities.

In our international segment, net sales were \$54 million, up 14% compared to year ago, and were negatively impacted by 3 percentage points from changes in currency exchange rates. Our international segment remains strong in the quarter, with robust sales.

Turning to line of business, worldwide net sales of multimedia learning were up 10%. Platforms were up 18% year over year, driven largely by sales of LeapPad Ultra, LeapPad2 Power, and LeapPad2 holiday bundles in the quarter. Content sales were up 2% and accessories were down 11% compared to the prior-year period. Within multimedia learning platforms and content is our traditional reading business, which includes our new LeapReader, a Learn to Read and Write system. This category increased 4% and met our expectations.

Moving on to learning toys, worldwide net sales of learning toys declined by \$7 million due to lower sales of our end-of-life toys; and a shift in toys sales to earlier in the year to accommodate our retail partner, end-cap promotions that occurred in the second quarter of this year.

Gross profit for the quarter increased 3% to \$79 million compared to the prior year. Gross margin rate was 39.5% for the quarter, down 50 basis points year over year as a result of a higher mix of lower-margin hardware sales. Slightly higher discounts and allowances also negatively impacted gross margin year over year, but was offset in part by lower expense related to excess and obsolete inventory product.

Operating expenses for the quarter were \$36 million, down 10% compared to \$40 million a year ago, and down 279 basis points as a percentage of net sales. SG&A and R&D both decreased significantly due to a reduction in the provision for incentive compensation expense, due to a rise of projections of full year financial results and well-controlled spending.

Net income on a GAAP basis was \$26 million, a decrease of just over \$15 million year over year. And net income per diluted share was \$0.37, a contraction of \$0.23 compared to the \$0.60 reported in the prior year. Net income in the prior-year period included a nonrecurring tax benefit of \$6.4 million, which was not experienced in the current-year period.

In addition, tax expense for the US was not recorded in the prior year due to the full valuation allowance against our domestic deferred tax assets. So, normalized net income and normalized net income per share -- which adjusts for these tax items and applies a 37.5% tax rate to each year -- are \$27 million and \$0.38 in the current year, compared to \$22 million and \$0.32 for the third quarter of last year.

Let us move on to the balance sheet. Cash and cash equivalents finished at \$78 million, an increase of \$29 million over the \$49 million reported a year ago, despite a reduction of \$23 million in accounts payable due to the timing of purchases. As a result of our strong cash position, we do not anticipate drawing down our ABL this year for the second consecutive year.

Our accounts receivable balance was \$185 million, an increase of 9%, which was higher than our 4% net sales increase, due to timing of order shipments occurring later in the current-year period. Our portfolio remains healthy. Our inventory balance was \$122 million, up \$7 million or 6% compared to a year ago, primarily due to new product launches, and inventory build of our expanded product line in preparation for the holiday season.

Property and equipment increased \$12 million to \$32 million, primarily due to hardware and software purchases related to new systems and new online initiatives. Accounts payable declined by \$23 million to \$59 million, from \$82 million last year, due to the timing of purchases. In summary, our balance sheet is in excellent shape heading into the holiday season.

Now, I'd like to finish my prepared remarks with insight into our full-year outlook. While our reported results in and through the third quarter of 2013 are strong, and we remain committed to driving earnings growth through increased net sales and tight expense control, we anticipate a challenging holiday season in the US.

Regarding guidance, given concern related to the overall retail environment, lagging retail point-of-sales trends, and a compressed holiday season in the US, we are reducing our full-year 2013 guidance. Our guidance is based on our best view as of today. We now expect full-year 2013 net sales to be in the range of \$570 million to \$590 million, or plus or minus 2% compared to 2012; and normalized net income per diluted share to be in the range of \$0.36 to \$0.40 compared to \$0.56 in 2012.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mike Swartz, SunTrust.



Mike Swartz - SunTrust Robinson Humphrey - Analyst

Good evening, guys. Just a quick question, did you say that POS at retail was down year to date, or down in the third quarter?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

It's down, year to date.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Okay. And have you seen anything accelerate or change since the end of September, going into the first week of November?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

We don't get into monthly POS trends. I would say we have shifted a lot of advertising into November and December versus in October last year.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Okay. And just in terms of the four-year outlook, and understanding that there's six less shopping days this year, is there something that has changed the outlook? Because I would assume that the six fewer days were already accounted for when you previously gave guidance. So does this just tell us that there's been some pretty weak retail trends? And with that, how do you feel about inventory levels at retail right now?

John Barbour - LeapFrog Enterprises, Inc. - CEO

Well, I think if you look at quite a few other companies that have announced their results over the last few weeks, I think people have been fairly consistent with the softness out there in terms of US retail. So I think the trend is pretty clear to everybody out there that US retail in itself is pretty tough. You just have to look at Walmart's guidance for this year just to see how tough it is. So, the fact is is that, yes, when we did our plan for the beginning of the year, everybody knew there was -- we've been talking about six fewer shopping days for quite some time.

However, it's the impact those six fewer shopping days have in a tight marketplace, because what it does do is it magnifies the challenges. So there are six fewer shipping days to react to later sell-through. There's a number of other issues, as I mentioned in my remarks, that have an impact. So, yes, we knew there were going to be six fewer shopping days. But I think it's the tightness of the marketplace at the moment, especially in the US, that's causing us concern. And when we sat down and mulled the numbers based upon that, and slower POS than we expected, then we're concerned about the way the Q4 looks.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Okay. Thanks for the color, guys.

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

Let me take this opportunity to also correct something I said. I inadvertently gave you guidance of \$0.36 to \$0.40 for the year. It's really \$0.36 to \$0.46 for the year, compared to \$0.56 last year. I just want to make sure I got that on the record.



Operator

Drew Crum, Stifel.

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

Good afternoon, everyone. I wondered if you could comment on what you're seeing across the business in terms of weakness. Is it category-specific, or is it broad weakness across the business?

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

There's always little its and bits across categories, but the business is softer than we expected across the business. And, I'll say it again, and you've seen the results from other people -- it's at the moment predominantly US issue. Retail is very tough out there at the moment, although some of the developed countries are showing some toughness as well. But it's across the business.

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

Okay. And, Ray, the fourth quarter, the implied revenue guidance for the fourth quarter, can you talk about what that implies for international?

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

For international?

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

Yes, are you anticipating growth for international?

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

Yes.

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

Okay. And just one last question, JB. The LeapReader -- new product for you guys. Can you comment on the performance relative to Tag? I think in the past you suggested that Tag consistently sold at least 1 million units annually. How is LeapReader performing relative to Tag? Thanks.

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

Yes. LeapReader, as you look at it right now, has been affected by the market softness. We've just started doing TV on it over the last few weeks, and we're seeing some very nice pickup. We still see it as a good introduction for the year.

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

Yes, and that reading business is up for the third quarter.



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

Thanks, guys.

Operator

Sean McGowan, Needham.

Sean McGowan - *Needham & Company - Analyst*

Good evening, guys. How are you? I've got a couple of questions here as well. What are retailers telling you thus far about the sales of LeapPad products relative to other tablets? You talk about competitive factors and more price competition, but what's happening in LeapPad's position relative to other tablets?

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

Well, we read the POS, and we're seeing the POS all the time. What we've got to do is we've got to factor in the fact that our TV is running significantly later this year in LeapPad than last year. So that one is one that you've got to factor into whenever you look at the math. That's the main trend that's out there right now.

Sean McGowan - *Needham & Company - Analyst*

Okay. So they're not giving you any indication about whether or not there's been softness experienced at other -- even non-kid tablets?

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

We read our NPD numbers, which we focus in on the kid tablet space, and that's what we use as our guiding point.

Sean McGowan - *Needham & Company - Analyst*

Okay. Another question, then. So what -- you experienced, then, over the last, call it month or couple of months here, what does that say about the outlook for LeapPad Ultra in next year, when I would imagine there will be more competition and even more price competition than this year? What's your outlook for how the product will perform next year?

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

Well, I think we've got to get through the holiday season. But LeapPad Ultra is a great product. We're very happy with the product. We fixed the issues we had at the early stages of the product. As I said earlier, I was in eight stores all yesterday morning. And it was out-of-stock in a bunch of those stores, so it's certainly selling through as the TV starts to have an impact on it. We'll see where we get to the end of the year, but looking at this year right now, we still think it's a great product.

Sean McGowan - *Needham & Company - Analyst*

Okay. And then on the shift of advertising, I presume that's going to be reflected in the P&L, some greater advertising in the fourth quarter. Can you give us some guidance on what your expected advertising-to-sales ratio would be for the year?



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

No, we won't do it right now. But it's also shift in activity we've got with retailers as well. So it's not just that advertising; it's advertising that we work with retailers on as well, which will be in the promotional plan.

Sean McGowan - *Needham & Company - Analyst*

Okay, thank you.

Operator

Scott Hamann, KeyBanc Capital.

Scott Hamann - *Keybanc Capital Mkts - Analyst*

Good afternoon. Yes, JB, so just thinking about the retail and inventory levels on a year-over-year basis, I don't know if you actually quantify where you are right now.

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

We've not.

Scott Hamann - *Keybanc Capital Mkts - Analyst*

Does that mean you're not going to?

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

(Technical difficulty) traditionally (technical difficulty) retailers into our (technical difficulty), but I think it's safe to say if POS is slow, there's going to be some impact.

Scott Hamann - *Keybanc Capital Mkts - Analyst*

Correct. Okay. So, just in terms of the POS numbers, maybe even more recently, which products have been a little bit slower than you would like?

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

I think we've said pretty clearly, if you look across the board, the retail is pretty tough at the moment. And part of it is driven by shift in advertising and promotion, but I won't go into individual products. But what I can say is that the big part of our advertising just started last weekend, and is going to run for the next six weeks, and we'll see where it tumbles through.

Scott Hamann - *Keybanc Capital Mkts - Analyst*

Okay. It seemed like the content and accessories were a little bit weaker than I thought they would be. Is that a timing thing, or --?



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

I think accessories is a timing thing. Last year, we had a pretty big third quarter because we dealt more into accessories, and that allowed us to ship more into market. So I think it's just a comp issue for accessories. Content was up a couple of percent, which is (technical difficulty). But, again, if POS overall is soft, then you're going to see softness through the other categories, content being one.

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

Yes, we can see it a lot in the layaway numbers that we're getting from our big partners as well, which are also down this year on last year. Even though our products are performing comparatively well in the marketplace, the layaway numbers are down. year on year. Again, we're not the only ones that are experiencing a tough retail environment at the moment in the US.

Scott Hamann - *Keybanc Capital Mkts - Analyst*

Well, JB, from your seat, if you look at where you were maybe a few months ago to where you are now -- is what you're seeing in the POS trends, in your opinion, more of a macro, consumer spending concern? Or has it been a little bit more on the competition or wallet share shift, or how do you see that?

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

You get to see the results of other companies in the space, and you get to see what their POS numbers are as well. And I think if you look at that, pretty sure what most people have disclosed out there is POS is pretty tight or pretty down at the moment. Although, again, you've got more of an idea. But I could tell you right now, with layaway being down and POS being down in a number of categories around the marketplace -- certainly where it was last year -- there's no question the market is tougher going into this holiday season. When you add to that the six fewer days, which does have an impact the tighter the market becomes, that's why we have some caution going into this quarter.

Scott Hamann - *Keybanc Capital Mkts - Analyst*

Okay, great. Thank you.

Operator

Stephanie Wissink, Piper Jaffray.

Stephanie Wissink - *Piper Jaffray - Analyst*

Hello. Good afternoon, everyone. Just a couple of questions. A couple of questions for us. I want to just make sure I understand the fourth quarter outlook. So it sounds like you're extrapolating the quarter-to-date rate to the balance of the year, but you're also talking about some advertising initiatives, TV included. Can you just talk a little bit about the effectiveness of TV advertising in the past and some of your promotional work at retail? Should we assume some acceleration into November and December?

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

Yes, we're reading the TV as it goes at the moment. TV also has an impact, timing-wise, by when that consumers are actually shopping as well, and driving demand. But the reason we moved our TV was that we sat and we read tablet sales for last year from NPD, what it showed that sales tripled



from the month -- actually more than tripled in the month of November versus October. So, a bunch of activity that we executed last year in October, we shifted and moved into November. And we're hoping to see that activity pay off in a big way as consumers come out in their droves and want to start spending for the holiday season. And that's why we made that shift. It's a fairly significant shift, and we're at the early stage of that shift right now.

As I said earlier, I was in eight stores yesterday morning. And, of those eight stores, I think about six of them, LeapPad Ultra was actually out of stock. And it's good to catch those things at this time, so that we can all work together to make sure that product flows into the stores in a more effective manner. Again, when you've got fewer days to respond to those things, it does tighten things up.

But that's what we're doing in our advertising and promotion, and we feel that it's the right way to deal with things in a tough economy. It's always best to advertise when the fish are swimming.

Stephanie Wissink - Piper Jaffray - Analyst

So, if I could just do a follow-up. If the business were to accelerate based on the advertising plan, would that be upside to your guidance? Or are you guiding with that already embedded in the assumption?

John Barbour - LeapFrog Enterprises, Inc. - CEO

That's a tough call. We're guiding at the moment based upon the numbers that we've calculated at this time. If suddenly the economy picks up and the advertising does better than we think it does, and the retailers can actually -- we can get the product to the retailers and get it on shelf time -- yes, there could be there upside. But there's a lot of ifs in there.

Stephanie Wissink - Piper Jaffray - Analyst

Thank you, guys. I appreciate it.

Operator

Ed Woo, Ascendant Capital.

Ed Woo - Ascendant Capital Markets - Analyst

Thanks, guys. I had a question in terms of international sales. It seems like a lot of the focus on the lower guidance was in the US. But at the same time, you mentioned that you expect growth in international. So are you saying that, right now, international seems to be a lot better than the US?

John Barbour - LeapFrog Enterprises, Inc. - CEO

Actually, if you look at the numbers for Q3, international in the developed markets actually had a bit of a slowdown as well. Again, reading a bunch of the reports out there, a lot of people are talking about upside in the less developed marketplaces. But right now we've seen a slowdown in the developed key markets in Q3 as well, so we're watching that closely. But we would expect to grow our sales in international in quarter four, assuming that slowdown changes as we go into the peak of the season.



Ed Woo - *Ascendant Capital Markets - Analyst*

Great. And then the other question I had is it seems that you guys are increasing your capital expenditures a little bit. Does that mean -- is there anything you can share about maybe acceleration of some of your products into other non-English-speaking countries, particularly the LeapPad2? Or is there other initiatives that you will probably just go with later on?

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

We continue to work on our Web initiatives, our commerce initiatives. We have Learning Path, which is going to get rolled out shortly. And we do have expansion initiatives that we're working on, which we prefer not to get into detail about from a competitive standpoint.

Ed Woo - *Ascendant Capital Markets - Analyst*

Okay. Well, thank you and good luck.

Operator

Jim Chartier, Monness, Crespi.

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

Good evening. Hello, guys. First, on the ad spend, was this a shift from third quarter into fourth quarter, or just from October into November-December?

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

October -- there was actually a little bit of a shift -- if you look at our numbers, we advertised in the midterm, I think it was, last year, and a little bit in September. So we took that advertising, we put it into the fourth quarter, and then we're also shifting around brand and across brand through October-November. And we've also changed some of our promotional activities with our major customers to focus on November as well.

So, I would say it's not just one single thing. There's a whole bunch of complicated moving parts. But that will give you at least a sense of what's happening.

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

Okay. And then on the assumptions for fourth quarter, can you give a sense what your assumption for POS is? I know someone asked earlier, but are you assuming the POS stays the same as the current trend, more proof of advertising. And then it looks like a huge margin degradation in fourth quarter. Is that primarily on the gross margin line, or deleverage on expenses?

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

We're hoping that -- as everybody says to us, Christmas is going to come. And that's been in a bunch of the comments out there about the six fewer shopping days. I think, yes, consumers are going to spend money over the holiday season. Whether they spend the same amount of money as last year, we'll find out when it comes to the holiday season. I think that issues that we've got over the six fewer days are more operational and executional issues for everybody. But certainly with our advertising, we would certainly hope that that POS improves into the fourth quarter.



Ray Arthur - LeapFrog Enterprises, Inc. - CFO

But this could become a very -- more competitive pricing, discounting environment as well, with all of the tablets that are out there in today's environments with the kind of POS trends that exist today.

John Barbour - LeapFrog Enterprises, Inc. - CEO

Yes, there's certainly a significant number of new competitors in the marketplace. And in a tight marketplace, that usually results on price competition; but also clearance activities as the strong and the weak get separated, and retailers want to clear their inventories. So, we're certainly expecting the marketplace to be a lot more price competitive this holiday season.

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

So, should we expect the decent discounting on the Ultra, Power, or -- beginning in November-December? Is that (multiple speakers) with the guidance?

John Barbour - LeapFrog Enterprises, Inc. - CEO

I think that's a great question, and we'll see how it flows.

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

And then just again to the earlier question, in terms of the operating margin degradation of fourth quarter, is that primarily gross margin or SG&A?

Ray Arthur - LeapFrog Enterprises, Inc. - CFO

It's primarily gross margin.

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

Okay. Thank you.

Operator

And this does conclude today's question-and-answer session. I will now turn the call back over to Karen.

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

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

Operator

And, ladies and gentlemen, this does conclude today's conference call. You may now disconnect.

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