



Dear fellow shareholders:

What a year! It was a year of exhilarating favorable momentum (the first nine months), and a year of jarring economic collapse (the last three months).

As planned, LeapFrog successfully brought to market a portfolio of new and innovative products in 2008 including three compelling connected products: our acclaimed Tag reading system, a web-connected version of the original Leapster handheld called Leapster2, and Didj, the first customizable gaming and learning system for kids. Tag, our strategically important new reading system, launched to enthusiastic customer satisfaction results and received 28 awards including Educational Toy of the Year in the United States, Australia, and France. Importantly, we also introduced our breakthrough learning feedback technology, LeapFrog Learning Path, and the extensive network of reward systems, parent community and advice forums, online demonstration areas, and consumer marketing systems associated with it.

The momentum created by our new products accelerated into the first three quarters, driving sales results up 23 percent. Gross margins trended upwards, and we produced a healthy operating profit in the third quarter. Then consumer sentiment in the all-important fourth quarter fell off sharply...a nine percent year-over-year reduction in retail demand according to U.S. Department of Commerce estimates<sup>1</sup>...and resulted in the worst holiday toy industry performance in over 25 years. Weakening demand led to steep competitive discounting and the consumer shifted her orientation towards less expensive products. Our holiday sell-through was poor in this environment, and our net sales declined 24 percent year-over-year in the fourth quarter. We ended the year with a very high level of inventory in the channel, and we expect the first half of 2009 to reflect the continuing drag of a weak global economy.

Despite the surge of challenges during the fourth quarter, LeapFrog drove financial progress. Sales grew seven percent year-over-year in the United States and four percent overall to \$459 million for 2008. Our net loss narrowed 33% to \$68 million, or \$1.07 per share. We recognized several unique charges and provisions directly tied to the weak economy, yet our gross margin improved slightly and we reduced operating expenses by 12 percent year-over-year. Operating cash flow was \$12 million, an improvement of \$27 million from a year ago, and total cash use for the year was only \$14 million. We maintained a healthy balance sheet and ended the year with a solid cash position of more than \$79 million, inventories of approximately \$58 million, and no debt.

We have done extensive post-analysis and research regarding the year 2008, with a particular focus on the fourth quarter. In hindsight, we believe that we could have discounted more at the end of the holiday, and perhaps adjusted our ad campaign to "sell harder." However, we do not see any marketing technique, or product adjustment, or supply-chain demand forecasting model that could have compensated for the unprecedented drop in general consumer demand throughout the economy which occurred.

<sup>1</sup> Based on data from the Advance Monthly Retail Trade & Food Services Survey as published through the U.S. Census Bureau. Data compares Retail Sales Excluding Food Service for the months of October through December 2008 to the months of October through December 2007.

As companies worldwide begin the process of organizing themselves for the slowly recovering and de-leveraged economy which lies ahead, where is LeapFrog? Simply put, we think that with our brand, new products, our much lower cost structure, and strong balance sheet, we have a bright future. Let me be specific:

### **A Strong Brand and a Connected Product Portfolio**

LeapFrog brand awareness and product purchase intent scores increased in 2008 with the rollout of our new web-connected products including one clear strategic “winner,” the Tag reading system, our first new reading platform since our LeapPad system was introduced in 1999. Based on industry data, LeapFrog gained market share in the electronic learning category of toy products and is the clear sales and brand recognition leader in the category within the United States. The introduction of our proprietary Learning Path was well received and this online tool for parents and kids has become one of our key differentiators in the learning toy space. Early data indicates that a consumer who has engaged with the Learning Path has a value to LeapFrog over 10 times that of a non-Learning Path consumer. As we head into 2009, we have nearly one million connected consumers, and we believe that by year-end that number should increase to nearly three million consumers in our play-and-learn “ecosystem.” In 2009 and 2010, we will see our connected portfolio, and our online product portfolio, improve and expand.

### **Retaking Reading**

Tag performed well in its introductory year, beating internal sales plans and delivering tie ratios (ratio of software unit sales to hardware unit sales) exceeding those of our former hit product, LeapPad. Historically, the reading category dominated our business at about 60 percent of sales, and by the end of 2007 had declined to about 10 percent of sales. Because of Tag, today our reading segment is back and growing among four to six year-olds. Our Tag Junior book pal will launch in summer 2009 to help children ages two to four develop a love for reading and books. We will add to our expansive Tag library with the release of more than one dozen exciting new Tag book titles this year.

### **Expanding Our Leadership in Educational Gaming**

Handheld educational gaming is, by far, our largest and most successful business area. We had our biggest year ever in educational gaming led by Leapster and Leapster2 and the introduction of Didj. This category was a strong performer during the 2008 holiday season, despite widespread competitive discounting. The Leapster franchise remains the clear handheld category leader in our age range with a high level of brand awareness among moms with children in the target age range of four to six year olds.

### **Building Exceptional Learning Content**

LeapFrog content (our books and games) is our best opportunity to drive margins upwards and smooth the seasonality of product sales. With that in mind, we have developed relationships with software developers and the best-selling entertainment brands and educational publishers to establish an exceptional array of games and characters from leading media properties. Our library of 22 Tag books, 33 Leapster titles and 11 Didj games includes exclusive titles introduced during 2008. In 2009 and 2010, we expect to see the breadth and caliber of our content expand and the integration of the content with our Learning Path improve. We also expect that our Learning Path system will improve our ability to sell more content.

### **Creating Value through the Learning Journey**

Web connectivity enhances the play and learning value of our products and is a cornerstone of the Learning Path, our online application that communicates each child’s progress and skill development

along his or her “learning journey” and helps customers transition to new products along the way. Web sales on LeapFrog.com, a major focus area for 2008, grew 20 percent year-over-year driven in part by more than two million Tag audio downloads through the Learning Path. Research results to-date show that Learning Path users have a significantly stronger affinity for the LeapFrog brand and, as I noted above, they are likely to be much bigger buyers of LeapFrog products. We believe there is substantial value to be created through this learning “ecosystem,” and future investments will emphasize the development, marketing, and monetization of the Learning Path.

### **Our Mission for 2009 and Beyond**

Nobody has clear visibility as to what 2009 will bring economically, but nearly all key indicators point to another challenging year in the marketplace. The recession will end eventually, and we will be in a good position to grow when that occurs. We are taking decisive actions to improve our products, stimulate content sales, sharpen price points where sell-through velocity or competition warrant, and introduce new lower price-point products into the learning toy line. We will also continue to find ways to run our business more efficiently and further reduce our cost structure as needed while maintaining the quality and liquidity of our balance sheet. In 2009, we are expecting substantial sales declines given current levels of retailer inventory and the challenges ahead. Yet, we still believe we will improve on 2008 cash flow performance due to higher gross margin products and a lower operating expense base. We have built our internal plans around break-even cash usage for the year.

LeapFrog’s strategic priorities are to invest in the core categories of reading, educational gaming, and our Learning Path “ecosystem.” Our marketing will be oriented to increasing consumer sales in these categories, to drive a higher percentage of content sales, and to catalyze new growth in the learning category. In 2009, we will see the launch of new connected products in our reading and gaming categories, as well as our learning toy line. Importantly, we will also expand our learning toy line, including our attractively-priced Scout assortment and the Zippity learning system, our first co-branded product with Disney. For 2010, our product development efforts are underway and we will “up the ante” in all of our product categories. By doing so, we believe we’ll be positioned for substantial earnings growth as the consumer begins to feel the benefits of a strengthening economy.

We are focused on the interests of our shareholders, and we are driving very hard to improve cash flow, strengthen our product line, and build demand among consumers and retailers for the LeapFrog brand. We have a lot of work ahead of us, but we firmly believe that with our brand, our products, our balance sheet, and our team, LeapFrog’s future is a bright one.

Sincerely,



**Jeffrey G. Katz**

Chairman and Chief Executive Officer  
LeapFrog Enterprises, Inc.

April 20, 2009

This letter to shareholders contains forward-looking statements, including statements about future financial results and anticipated product launches. Please see the special note on forward-looking statements on page i of the enclosed LeapFrog Enterprises, Inc. 2008 Annual Report on Form 10-K.