

LeapFrog (LF) Memo

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College/School: College of A&S

Year: 2nd Year

Important Company Financial Data (as of October 27, 2013)

Price: 7.73	ROE: 35.67%	Cash: 181.42M	Debt: \$0
P/E (ttm): 5.57	EBITA (ttm): 82.43M	Market Cap: 612.72M	Profit Margin: 16.19%
EPS: 1.39	Beta: 0.48	52 week: \$7.00-\$11.95	Revenue (ttm): 603.72M

Thesis / Key Points

- With regard to cheaper tablets, LeapFrog has a much **lower P/E ratio** at 5.57 than two of their top competitors, Mattel at 18.00 and Hasbro at 19.96.
 - While some of this is certainly due to the fact that these companies have fewer growth prospects because they are established as significantly larger multinational companies more focused on larger juvenile markets, a comparably sized consumer product company like SodaStream has a P/E ratio of 28.18, further illustrating how undervalued LF is right now. LeapFrog's growth potential is very high because of this.
- **New products** such as the LeapReader show innovation and have received strong online reviews from websites such as Amazon (4.5 out of 5 stars) and Wal-Mart (4.8 out of 5 stars). 90% of all product reviews on Amazon, Wal-Mart, Toys "R" Us, and Leapfrog received four stars or greater, with more than 4,000 Five-Star Reviews. Bad reviews were related to minor glitches on the LeapFrog Ultra, which have since been fixed.
- Sales growth for the first two quarters of this year was encouraging (See fourth bullet point for 3Q); LeapFrog has delivered market-leading sales growth of 16%, with 17% growth in international markets. They were also EBITDA positive for the three quarters of this year for the first time in the company's public history.
 - Gross profit increased 8% in the second quarter to \$31 million from \$29 million last year. This increase in sales was due to the introduction of new products such as the LeapPad 2 and the LeapPad Ultra, which have driven sales in the last three quarters. Multimedia learning platforms (LeapPad 2, LeapPad Ultra) dominate the sales that the Company has; 83% of sales were platforms while roughly 17% were learning toys in 2012. This is important in that this is a 10% increase from 2011, and this reflects well that LeapFrog's most highly rated products are representing a larger and larger percentage of sales.
 - **Very strong balance sheet** as evidenced by zero debt and \$181 million in cash as of 11/6/13. Management has enormous flexibility in using cash to **reinvest in the business, buying back their undervalued shares**, or potentially **paying a dividend on their shares**.
- Third Quarter Results were not as high as analysts projected, which led to a decrease in the stock price down to 7.73. I believe that this further strengthens this pitch. Consolidated net sales were up 4% and Adjusted EBITDA was up 14%. LeapFrog's third quarter results, while not as high as analysts projected, effectively drop the price down, further increasing the potential upside in Company's stock. It's a prime time to buy
- The Company has an enterprise value of only \$460 million with the aforementioned \$181 million on the balance sheet, making it a **prime takeover target** for larger players in traditional toy sector looking to expand into the lucrative educational entertainment field.
 - Retailers such as Toys "R" Us and Target have shown that they acknowledge the growth of the educational entertainment market by expanding their inventories in the last two years around the holiday season. LeapFrog CEO John Barbour has stated that the Company was open to being bought, and private equity firms have expressed interest in the past in an acquisition. In my opinion, there will always be a strong market for educational toys due to parental concerns about early childhood development, and LeapFrog's strong brand name coupled with its price, provides a competitive advantage that will allow it to continue to grow.
 - "The educational entertainment industry is a growing quickly, and LeapFrog's strong brand name and balance sheet as shown by zero debt and \$181 million in cash make it a prime target for acquisition by a larger player in the market." Associate at a mid-market private equity firm in New York City.

Misperception

- The Company is currently undervalued for several reasons. LeapFrog has experienced management issues in the past with indecisiveness and a lack of innovation, but most of the Company's current executives have joined within the last two years and have been instrumental in driving the key initiatives, such as the introduction of new products such as the LeapPad 2 and LeapPad Ultra spurring the recent period of growth.

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- Recent technical errors in the LeapPad Ultra have also scared some potential investors, but LF was quick to offer an update on their website that has solved these issues. Devices with new firmware began shipping out at the end of August. The stock dropped from 11.50 to 8.50, and still has not recovered. This, coupled with an underwhelming third quarter, has dropped the price to 7.73, which I believe is a major misperception. Fears of competition and the failure to meet analysts' projections are overblown.
- Investors remain cautious because of growing competition in the market, but none of LeapFrog's competitors possess its strong brand name or competitive advantage in price. For example, the LeapPad Ultra is priced at \$149 while an iPad Mini is priced at \$329. Apple's tablets have a variety of educational apps, but parents have shown that they prefer educational toys to letting a young child use their tablet. 13 million parents are now connected to LeapFrog's interactive system. TechAdvisor compares the LeapPad 2 and the InnoTab 2, a major competitive product, and concludes that the LeapPad 2 is far superior.

VAR

- "LeapFrog's products have sold very well here in the last few months, especially their new pad [the LeapPad Ultra]. I would imagine that the holiday sales will far exceed what we've seen in the past, and I'm sure we'll order even more of their products than we're currently planning to buy." –Store Manager at Toys "R" Us.

How It Plays Out

- LF's superior products and brand name have yielded a strong following of parents looking for a fun and educational experience for their kids. I strongly believe that LF is at a point where the historical mismanagement and recently overblown product glitches have driven shares to a level where they are extremely cheap. Following LeapFrog's releasing of third quarter earnings, which drove the price down as concerns about not meeting projections were met. However, these fears are almost certainly overblown, and the price is low enough to provide significant upside to the Company's stock. Another strong holiday season that beats expectations once again could provide 20% upside to LF's current share price of \$7.73. I recommend that MII initiate a 3% long in LF.

Risks / What Signs Would Indicate We Are Wrong?

- LeapFrog's risks include minor glitches in their latest product, the LeapPad Ultra, which customers have reported. The company offers simple steps to apply an update by visiting their website that so far seems to have great success and should not at all impact the holiday season.
- LeapFrog's sales are highly related to the successes of Wal-Mart, Toys "R" Us, and Target. These three companies have represented over 50% of gross sales over the last two years. If any of these companies suffers, LeapFrog's sales will surely take a hit.
- Management issues have plagued LeapFrog in the past, such as indecisiveness on the introduction of new products and conflict over the direction of the company. New management has presented a strong, united front in the last year, but their actions should be monitored moving forward.
- Increased competition in the last few years from educational entertainment companies such as Mattel and Hasbro, as well as Apple, which has recently pursued greater educational apps.
- LeapFrog's sales are dependent on discretionary income, so a downturn in the economy would likely cause a drop in sales as parents cut back on nonessential needs for their children.

Signposts / Follow-Up

- The success of the LeapPad Ultra's update and devices equipped with new firmware need to be monitored as the holiday season approaches.
- The gross margin % trends are also important to monitor in the coming months. The current 11/4/13 gross margin of 37.2% is projected to increase to 44.6% in the final two quarters of this year.
- LF's relationships with Wal-Mart, Toys "R" Us, and Target is extremely important, since LF is dependent on their sales. LF won a Wal-Mart Supplier of the Year Award in Quarter 1, which indicates a strong relationship between the two companies.
- Competitors such as Mattel and Hasbro's success in the

Company Description

LeapFrog ("LF" or the "Company") is the market leader in educational technologies for children. LeapFrog uses technology entertainment toys to educate children ages 1 to 10 in reading, writing, and mathematics to help them prepare for elementary school and beyond. LeapFrog's system, The Learning Path, allows parents to see where their children exceed expectations and their development in certain subjects, providing customized responses. LeapFrog has many pads, readers, and interactive game systems which parents can load a wide variety of books and interactive games onto as the kids grow older. LeapFrog's goal is to educate kids through play. Although based in the United States, LeapFrog's products are offered in 45 countries, with

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market should be monitored as well.

30% of sales coming from outside the U.S.



- LeapFrog's stock shows that it has suffered since the minor glitches in the LeapFrog Ultra, but it is beginning to recover.

Strong Momentum

2012 Top 10 Selling Toys in the U.S.

1	Explorer Software Assortment	LeapFrog
2	Beyblade Metal Fusion	Hasbro
3	LeapPad Explorer System Green	LeapFrog
4	LeapPad2 System Green	LeapFrog
5	Hot Wheels Express Lane Assortment	Mattel
6	Monster High Doll Assortment	Mattel
7	Easy Bake Ultimate Oven	Hasbro
8	Razor Scooter Assortment	Razor USA
9	LeapPad 2 Bundle Assortment	LeapFrog
10	Barbie 3-Story Dream Townhouse	Mattel

Top 10 toys in the U.S. ranked in dollar order. Source: The NPD Group / Retail Tracking Services, annual 2012. LeapFrog Investor Presentation | 17

- LeapFrog possesses 3 of the top 4 selling toys in the U.S.

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Appendix: Market Leading Sources

#1 Selling Preschool Electronic Learning Toy (1)	#1 Selling Learn-to-Read System (2)	#1 Selling Learning Game System (3)	#1 Selling Kids' Learning Tablets (4)	#1 Selling Learning Content (5)
				

Source: Based on The NPD Group / U.S. Retail Tracking Services, based on U.S. dollars, annual 2012.

- (1) U.S. Source: #1 Preschool Electronic Learning Toy based on The NPD Group/Retail Tracking Service as defined in dollars, annual 2012.
- (2) U.S. Source: #1 Learn-to-Read System based on The NPD Group/Retail Tracking Service; Preschool Electronic Learning, Learn-to-Read brands as defined by LeapFrog in dollars, annual 2012.
- (3) U.S. Source: #1 Learning Game System based on The NPD Group/Retail Tracking Service; Preschool Electronic Learning, Educational Gaming System brands as defined by adding LeapsterGS Explorer and Leapster Explorer dollars, annual 2012.
- (4) U.S. Source: #1 Kids' Learning Tablet based on The NPD Group/Retail Tracking Service; Preschool Electronic Learning, Kids Learning Tablet brands as defined by LeapFrog in dollars, annual 2012.
- (5) U.S. Source: LeapFrog Explorer Licensed and Non-Licensed Software Assortment was the #1 Toy in the U.S. based on The NPD Group/Retail Tracking Service as defined in dollars, annual 2012.



- LeapFrog is a market leader in educational entertainment, as evidenced by its market leading sources.