VTech's Acquisition of LeapFrog Conference Call

Friday, 15 April 2016

Opening Remarks

Grace Pang

Head of Corporate Marketing, VTech Holdings Limited

Welcome

Good day everyone. Thank you very much for joining our conference call today to discuss the acquisition of LeapFrog. Today we have our Chairman Mr Allan Wong here to take you through the presentation which is now available on our website under Investor Calendar section. After the call an archive of the webcast along with the transcript will be available on our website.

Disclaimer

Certain statements made during the call may include forward-looking statements relating to the operation of the businesses of LeapFrog and VTech. These statements are based on the current beliefs and assumptions of VTech management with respect to future events and they are subject to a number of significant risks and uncertainties, which could cause our actual results to differ materially from those projected in the forward-looking statements. You should therefore exercise caution when dealing in the securities of VTech. Now I will turn to our Chairman, Mr Allan Wong, to take you through the presentation.

Acquisition of LeapFrog

Allan Wong

Chairman and Group CEO, VTech Holdings Limited

Acquisition Completed

Thank you Grace and good day everyone. I am pleased to announce that VTech successfully completed the acquisition of LeapFrog by way of merger on 4 April and LeapFrog is now an indirect wholly-owned subsidiary of VTech. To give you some background, we announced the acquisition in February this year. The consideration was approximately US$72 million and the deal was financed through our internal resources.

Complementary Overall Strengths

We decided to make the acquisition because we saw many complementary strengths between the two companies.

In branding VTech clearly has a stronger position in Europe. According to NPD, we are the number one player in the Infant & Toddler Toys category in the UK, France, Germany and Spain. We also rank among the top three in our key Western European markets in the Electronic Preschool Learning Toys category. By contrast, LeapFrog is the stronger brand in US with high brand awareness among mothers.

VTech and LeapFrog also have different areas of strength in products. VTech is stronger in the standalone or learning toys whereas LeapFrog is stronger in platform products such as tablets and reading platforms. A little later on in this presentation, I will elaborate on how the two companies complement each other in different product areas.

Geographically, there is also a good fit. VTech currently sells electronic [learning] products in 85 countries, in 25 languages. We have a pretty well-established distribution network globally. LeapFrog is more US-focused. In the fiscal year 2015, 69% of its revenue came from the US.

We complement each other in terms of talent too. As VTech, we are very strong in technology and product engineering while LeapFrog has a lot of talented people engaged in content development as well as a strong education team.

Regarding cost structure, VTech has its own manufacturing facilities in Dongguan in China to manufacture our products. In terms of operations, we are also more cost efficient. LeapFrog outsources all of its manufacturing and also has a higher overheads in operations.

Complementary Product Strengths

As products are the key to success in Electronic Learning Products, I will focus a little while on the respective product strength of LeapFrog and VTech. As you can see from this chart, the sales mixes of VTech and LeapFrog are quite different. For VTech, the major portion of our ELP revenue comes from standalone or learning toys, while approximately 33% comes from platform products. At LeapFrog, it is the reverse. 68% of its revenue comes from multimedia learning platforms including LeapPad learning tablets, the LeapTV gaming system, Leapster learning game system, LeapReader learning system and related content. 30% comes from learning toys and 2% comes from other products.

If we take a closer look, we will see that VTech and LeapFrog each excel in a number of different product segments. As regards consoles and software, reading systems, standalone toys with keyboards and 3D character design, LeapFrog does a better job. For playsets, big boxed products, as well as technology-intensive and manufacturing-intensive products, VTech generally does better. In the following slides I am going to show you some examples of these products.

Consoles and Software

On this slide, we have LeapFrog multimedia learning platforms and software. The one at the top left-hand corner is the Leapster learning game system. The rest are different generations of LeapPad learning tablets.

Reading

In this slide is the LeapReader learning system, which has sold in good quantities over many years.

3D Character Design

On this slide, you can see several standalone toys with 3D characters and LeapFrog is good in designing such toys.

Toys with Keyboards or Alphabets

LeapFrog toys with keyboards and alphabets are widely recognised as delivering good educational value. You can see a few of those examples here.

Playsets

Turning now to VTech. Here you can see our Go! Go! Smart family of products including Smart Wheels, Smart Animals and Smart Friends. We introduced our first Go! Go! Smart Wheels product in the calendar year 2013 and the whole Go! Go! Smart range now enjoys considerable success. One of the factors in the success is that these products require the sort of long-term planning and investment which we actually are good at.

Big Boxed Items

On this slide are the big boxed items in our product portfolio. With our in-house manufacturing and know-how, we have a strong competitive advantage in offering such products to customers.

Technology-Intensive Products

We always say that VTech is not a toy company, but a technology company that does educational toys. Our technological expertise allows us to always stay ahead of the industry and come up with new gadgets for kids, such as the Kidizoom Action Cam, Smartwatch and the Kidizoom Camera.

Manufacturing-Intensive Products

On this slide, it shows you our Switch & Go Dinos, the 3-in-1 Zebra Scooters and the 2-in-1 Smart Ride-on Rocker. They are products that entail a high degree of complexity in their manufacture, another competitive advantage that our in-house manufacturing and know-how gives us.

Strategic Acquisition

So, in summary, this is a strategic acquisition. It will bring an immediate revenue contribution to the Group, although we expect negative contributions in the financial year 2017, given the current profitability of LeapFrog. We are, however, acquiring a well-known educational toy brand that will enhance our ability to develop learning content. The acquisition immediately broadens our product portfolio. Over time, we can also eliminate costs and investments that would otherwise have been incurred to compete with each other. Overall, therefore, there is no doubt that the acquisition of LeapFrog strengthens our global leadership in electronic learning toys.

Q&A

Timothy Lee (CLSA): Thanks management for giving us about the acquisition of the two companies. Actually I would like to ask a bit more about how you would like to achieve the synergies as Chairman just mentioned VTech and LeapFrog have different niche for each of the entity. How you will achieve this kind of synergy like are you using the sales channel of each other to sell both parties products? And, regarding manufacturing, will LeapFrog's products be manufactured in the plants of VTech? Can you please elaborate a more bit on that? And secondly, I would like to know about what target break even time for LeapFrog? Do you have any ideas on that? And thirdly, regarding the dividend pay-out ratio Chairman also mentioned that in 2017, you have a negative contribution. Would that affect the dividend pay-out? These are my questions for now. Thanks.

Allan Wong: Okay. For your first question, all LeapFrog products will be sold through a single sales team. Therefore, we will not be having two separate sales teams. Therefore, both LeapFrog and VTech products will be sold through the same channel and the same sales team. So, we have some economies of scale. Also as I mentioned in the slides, we have complementary product lines. LeapFrog is stronger in the platform products, while

VTech is stronger in the standalone products. Therefore, added together we actually complement each other very well.

The issue is LeapFrog outsources all their manufacturing, and those manufacturing will eventually be taken in-house. We probably will not be able to achieve 100% in-house manufacturing, but over the next two years, we will be able to manufacture all LeapFrog's products in-house. Thereby that would give us additional flexibility and gross margin in the vertical integration.

As your second question as I mentioned on my slides, the first year which is fiscal [year] 2017, because it is the first year of the consolidation, we will inevitably have a negative contribution from LeapFrog, because LeapFrog has been loss making for so many years. Therefore, it takes time to turn around the operation, but by fiscal [year] 2018, we will be able to achieve positive contribution.

The third question; will the negative contribution affect the dividend pay-out ratio? I think it is too early to say at this point. We will see how the consolidation and the integration goes. I think by probably end of this year, calendar year, we will have a better idea.

Timothy Lee: Just to follow-up then, is there any target margins, either the gross margin or net margin, do you have any idea how it would be in the first like one or two years of operation?

Allan Wong: I think it will be for the second year, we should be able to achieve the same type of gross margin as what VTech has been achieving with the additional sales.

Timothy Lee: Okay understood, thanks very much.

Felicity Smith (Hempshill Hall Asset Management): Thank you. Thanks for taking my questions. I have just a couple. The first one is, are you expecting any significant restructuring charges? And over what timeframe and what amount would you expect? And, my second one is, you said that you expect to take all the manufacturing in-house over the next couple of years. Will that involve you having to add any capacity to be able to do that? Or, will there be costs for negotiating out of the manufacturing contracts that LeapFrog currently has?

Allan Wong: Yes, for the first year, there certainly will be some restructuring that need to be done. And that is the reason why for the first year, which is fiscal [year] 2017, we said we will – LeapFrog will have some negative contributions to our results. And that is because of some of the restructuring charges that we have to take through. However, it will be all done by 2017. So, by 2018, we will be able to, first, consolidate almost all of the manufacturing into the VTech facilities, and we will have positive contributions from the operation.

As to your second question, we have certain flexibility in our manufacturing capacity. We probably have to add some of the machineries, but as far as floor space is concerned, we do not need to add any factory floor space to consolidate the sales of LeapFrog. So we are able to do it within our existing capacity. And the capex involved in some of the additional machinery is not high. It is probably within our normal capex.

Felicity Smith: Have you got to negotiate out of existing manufacturing contracts to be able to bring that manufacturing in-house and are there costs associated with that you would be taking in 2017?

Allan Wong: That is why we said it will probably take two years to bring everything in-house. So 2017, that means in fiscal [year] 2017, we estimate we are probably able to bring about 30% to 40% of manufacturing in-house again because of the time involved, and the lead time involved in the tooling and in some of the initial setups. However, by 2018, we should be able, at least our plan at this point is, to bring almost everything in-house for manufacturing.

Felicity Smith: Okay thank you.

Warren Howe (Capital International Group): Mr Wong and Grace, congratulations. Most of my questions were asked, but maybe just to follow-up. The trend of contribution from LeapFrog in the last disclosure which was unaudited seem to suggest an actual growing trend of losses. So maybe just explain the background to that and maybe how you are going to turn around those issues. You have explained some of it already on the synergy question. And then secondly on the cyber-attack, if there is any update on the kind of financial impact of that, post that event?

Allan Wong: Okay. Thank you for the questions. First of all, if you look at LeapFrog's results, there is no question that their losses are actually widening in the last couple of years. The main reason is because of, first of all, reduction in sales, and also write-off of inventories, they have excess inventories. Now after our acquisition and after the restructuring, you can see that the main area that we will retain from LeapFrog is on the content development, product development, and some marketing team, and also on the education team. So we do not – we have actually consolidate all the other functions into our existing operations. And thereby been able to reduce the overheads and the SG&A by a significant amount.

Also, by bringing the products in-house for manufacturing, we have gained additional points in the gross margin. That is why in our plan, in the first year we will have some restructuring charges, and hence some negative contribution on the first year. However, by second year, we would be able to achieve the full gross margin effect at VTech, plus the additional benefit of a stronger development team that we will be able to come up with better products in the longer term for both VTech and LeapFrog.

Okay, again, on the cyber-attack, nothing new to report at this point other than what we have been announced so far. As far as the financial impact is concerned, we still do not have any concrete updates on the extent of the financial impact, both on the class action lawsuit and also on the FTC issues. Those things move very slowly, and I think as soon as we have any more concrete updates, we will be able to let the market know. We believe that by year-end, which is the announcement of our final result which is in May, I think we should be able to have some more concrete figures. However, at this point I think the variance is way too big to make any prediction at this point.

Warren Howe: Thank you.

Allan Wong: Okay.

Katerina Irwan (Eastspring Investments): Thank you. Mr Wong and Grace, just quick follow up questions on the cyber-attack. This one will implicate that you eventually want to continue using this VTech brand for your platform? I mean, at the moment you will have two brands. How do you want to handle it? Do you want to keep both brands separately? Or you will choose to use LeapFrog for your platform? I mean, just give us some colour on how you manage your brands.

And secondly, in terms of marketing and sales channel, at the moment is there overlap already between your channels that you can actually leverage?

And the last one on follow up for the overhead cost, will you able to give us a guidance on, at the moment how big is the staff cost in LeapFrog that you can roughly, like 50% or 70% off the staff costs that you save with merging the back office or more admin staff going forward? That is all, thank you.

Allan Wong: Okay. As far as what product range to go under what brand, and this is something that we are coming with what we call a dual brand strategy. As I mentioned in my presentation, LeapFrog is stronger in platform products, VTech is stronger in standalone products. VTech is also stronger in certain countries and LeapFrog is certainly stronger as a brand in the US. Therefore, we are compiling what we call a dual brand strategy, as I said earlier. This strategy is not new to us. If you remember in our telecom, we have been using our dual-brand strategy very successfully. Both AT&T and VTech to compete in the market. So we will leverage our experience in what we have done in the phones area and use some of those learnings in carving out our dual-brand strategy.

Certainly with two brands, there are a lot of flexibilities in what we can do in terms of products, and the most important thing, at this moment, is rather than competing with each other, VTech and LeapFrog, we can now align our efforts to actually compete in a bigger market and achieve a higher market share, rather than fighting with each other. I think that is a main benefit of having the two brands and not actually competing with each other, with the two brands.

Now, second question is your marketing and sales, is there any overlap. As I said in my presentation, we are stronger in certain part of the categories and we are also stronger in certain markets. LeapFrog is stronger in the US and also in certain countries they also have more success than VTech. Therefore, it is an immediate complement with what we are doing. As I said earlier, we do not even need to use two separate sales and marketing teams. Our sales and marketing team, our sales teams are certainly consolidated into a single team which have a lot of synergy. In addition, we can leverage our logistics, fulfilments and everything. You do not need to have two separate logistics and fulfilments, so we only need to have one fulfilment. That is why we can reduce the SG&A in terms of the whole operation. And after this year, after we have brought everything in house for manufacturing, we actually save a lot of logistics costs as well, and that is the reason why for next year we will be able to achieve the same type of gross margin with the additional sales consolidated from LeapFrog as what VTech can achieve.

Overheads cost, just to give you some idea as it is public information, at the time of our acquisition, that is by the end of March, LeapFrog had over 300 people. Of course, after the restructuring, the number of staff required will be a lot less, mainly, as I said earlier, we will be retaining all these content development people, the educational team and also some marketing staff, and that is the main area that we will be retaining. All the others, like the logistics and also the other overheads, we can actually consolidate it together with our own team. So we will have a lot less number of staff going forward than the 300 at this moment, and that is the reason why we can improve the efficiency and reduce the staff cost. Okay?

Katerina Irwan: I am not sure if you can say on percentage point, but I guess it is probably too sensitive to say it now. I mean, I understand how 300 people should [inaudible] about 30% reductions or 50% reductions, I know it is not that straight forward but, in overall, how big is the overlap that you have at the moment to have some sense that synergy that we can get from just low hanging fruit like logistics, fulfilments, staff costs or even channels.

Allan Wong: Exact percentage, I think it is too early to say. Just to give you some idea, for example in Europe they have their own office in France, UK, so obviously those additional people in those countries can be consolidated into our own sales and marketing facility without any additional overheads. And then, in terms of the 300 people that they have today, there are about 100 people are in the content development, in terms of the education team, product development and also under marketing. So those are the areas that we will be focusing more. And that is all I can say at this point.

Katerina Irwan: One last point.

Allan Wong: Yes.

Katerina Irwan: Yes, thank you very much. So it is just one last one. In terms of revenue, do you still expect LeapFrog, I mean, to be able to retain whatever top-line sales that they have been growing last year? Or do you think that because there is excess inventory that there is some channel clean up you need to rectify the inventory first, therefore it will impact the top line of LeapFrog for 2017?

Allan Wong: 2017 is generally fixed. We probably expect the same or slightly lower revenue than the previous year, but it is our goal for fiscal [year] 18 to increase the revenue of LeapFrog products over the last two years.

Katerina Irwan: Yes, thank you very much.

Allan Wong: Thank you.

William Hanbury (Waverton Investment Management): Hi there, thank you. I was just wondering if we could have an update on the competitive environment with respect to the console software, products of LeapFrog and the keyboards and alphabets products, and also whether the trajectory in those products is similar to what you see in the VTech platform products. Are those the same trends that are impacting all those products, or do they have divergent growth trajectories?

Allan Wong: Yes, if you focus on the platform products, LeapFrog is the leader in educational tablets, although that market is being eroded by some consumer electronics tablets. However, LeapFrog is still the strongest name in the educational tablets area, and with VTech and LeapFrog combined together, we are able to dominate the children's educational tablets area. And we believe that although the market may not be as big as what we have seen before, again because of consumer electronics tablets coming into that area, we still think that we have a fairly good focus and market share in the children's educational tablets.

William Hanbury: Okay.

Allan Wong: So we believe that we will continue with the tablets in both LeapFrog and VTech and then dominate that particular area. And then LeapFrog and VTech combined together have a very extensive software library and we both have over 1,000 software.

William Hanbury: Okay.

Allan Wong: Combined together we have the largest library of educational software for tablets.

Now in terms of other platforms, LeapFrog also has the LeapTV, which is a TV console product. VTech also have other platform products, like the smartwatch. We do complement each other in different platform areas. Therefore, we believe that LeapFrog and VTech combined together, we have a competitive advantage to really dominate in this area.

William Hanbury: Is the rate of erosion of the educational tablet market is that as fast as it has ever been or are you seeing any signs of stabilisation, or is it accelerating, I am not sure?

Allan Wong: I think it will stabilise. There is always a need for tablets specially designed for children. I think there is definitely an intrinsic market need for those products. Of course over the years there are mothers who have actually downgraded their tablets to give them to their children while they upgrade to something more advanced. There are also cheap no-name consumer electronics tablets that pretend to be an educational tablet for children. But the main thing here is the content. As I said earlier, both VTech and LeapFrog together have, combined, over 2,000 educational software; we are probably the biggest software library on the market. Therefore, whoever buys LeapFrog or VTech product has access to the huge library. No other tablet offers this extensive educational library. Therefore, we do believe that the market will stabilise at a certain level, probably at this level, we do not expect further deterioration. In fact we expect additional market share gain while VTech and LeapFrog combined together, in terms of the tablet area.

William Hanbury: Thank you very much.

Jun Yu (Pyrford): Thank you so much Chairman Wong and Grace and congratulations again. I have three questions. Number one: just follow up on the combined two dominant brands in the States. Obviously there will be reduced competition. Do you expect to see any ASP stabilisation or perhaps some other increase in some product lines going forward and thereby contributing to the top line growth, perhaps as soon as this year? Or will you make a different pricing strategy to gain more market share, more volume growth? That is the first question.

The second question is in the past you mentioned that you gradually moved towards Asia Pacific in terms of new growth opportunities, particularly in China. With this acquisition in the US, will that change the geographical focus as a long term development strategy?

And the last question is related to the dividend again. I understand that you mentioned previously you wanted to keep about US$300 million dollars in your account before considering any payment to the shareholders. Are you still holding on to that statement or with this acquisition that could change? Thank you.

Allan Wong: Well, when we combined the two brands together, LeapFrog and VTech, the biggest benefit we have is rather than competing with each other in certain products, we are now able to diversify our product line to gain a bigger market share together in the market place.

For example, we are very successful with the Walker, also LeapFrog came up with something similar to compete with us. When we combine the two companies together, we can actually spend our resource to come up with newer products to compete with other competitors, whether it's Lego or whether it's Fisher Price, whether it's Little Tikes. So we are able to combine our energy and our development expertise, which in this particular case is LeapFrog contents, software development and then we have our strength in technology development to come up with better products to compete in the market place. Of course our ASPs – I should not say that we will be able to increase our ASPs, but nonetheless, without us competing with each other, we can certainly stabilise the ASP in the market. Fortunately, in this market environment the material cost is an advantage. Plastic prices are coming down and also Renminbi and labour costs are stabilising and coming down slightly too, so all these are helping us to stabilise the ASP.

Your second question: geographic focus. As I said earlier, LeapFrog is stronger in certain markets and we are stronger in other geographic markets. The LeapFrog brand is certainly stronger in the US and also the UK. Therefore, we are able to leverage each other in those different markets, which is, again, extremely beneficial to us in those markets. We, as a combined company, LeapFrog and VTech, are certainly a much stronger leader now in terms of children's educational products than each one of us individually.

In terms of China, we are making certain inroads in China. The VTech brand is now making a good inroad into China. LeapFrog is still quite new to China, but certainly has potential in Asia Pacific and China because LeapFrog is considered to be a well-known overseas brand, so is VTech, but LeapFrog has actually in the past been quite aggressive in China, so there is certain brand awareness of LeapFrog in China. Therefore, with the LeapFrog products we are able to offer some additional opportunities in China as well.

Dividends, again, it is too early to say. We always like to be conservative. We always like to be able to not borrow from the bank even at our peak cash requirement months. This is always our goal. Therefore, it is too early to say what type of dividend pay-out ratio at this point in time. Probably closer to year end we will be in a better position to update on the dividend going forward.

Jun Yu: Thank you.

Eric Lau (**Citi Investment Research):** Hi, Mr Wong, congratulations for the deal. I have three questions. The first is: LeapFrog gained around gross margin 28% in the latest fiscal year, which should be at least 10% points lower than you are. I was just wondering about the difference: is it because they do not have the in-house production or anything, or is there any reason behind this? That is question number one.

Number two: regarding the co-brand strategy, actually unlike telecom products that are quite well defined in the sense of AT&T focus on commercial phones, VTech brand focus on household phones – that is very well defined. Say for tablet, you have the product, LeapFrog has the product, so how will you make the boundary between LeapFrog and VTech? You mentioned that VTech focus on standalone while LeapFrog focus on platform. Is that the on-going strategy for this definition?

Number three: your stock valuation is also supported by the generous dividend policy but going forward probably you have to invest for LeapFrog or do the provision. Any downside risk for the dividend policy? Thank you.

Allan Wong: Thank you. The gross margin of LeapFrog is lower. The 10% points difference, as you rightly pointed out, is they have to outsource the manufacturing, and with that outsourcing they require a bigger overheads relating to the logistics and outsourcing. The lower percentage also comes from certain provision of products that are not sellable, they have over-inventory. Particularly for these couple of years. Of course if you look at their previous year their gross margin was much higher.

As far as the branding is concerned, we are in the process of coming up with this strategy. It is not as simple as just we focus on standalone and they focus on platform. LeapFrog is a very well-known brand in the US as an educational brand. Their products are considered to be more educationally focused, while VTech is more fun focused. This is one way of positioning it. We are still in the process of coming up with this co-brand, but whatever way we synergise the two brands together, the combined LeapFrog and VTech, there are always a certain clientele that favours certain brands. The two brands combined together can always achieve, in our opinion, one plus one is bigger than two.

Your third question about dividends, again it is too early to say. The consideration for the acquisition is not a huge consideration in the whole scheme of things that we have had, but nonetheless it is cash outlay. Again, it is too early to tell whether we are able to keep, what type of dividend pay-out ratio, are we able to maintain the dividend pay-out ratio or are we able to make adjustments. Towards later on in the year, we are in a better position to know what those pay-out ratio will look like.

Eric Lau: Mr Wong, sorry, can I have a follow-up question regarding the gross margin.

Allan Wong: Yes, please.

Eric Lau: If LeapFrog used the in-house production strategy, will their gross margin be higher than VTech? I mean, for the comparable division?

Allan Wong: It will at least be similar to VTech, yes.

Eric Lau: Likely for higher or lower side, you think, compared with VTech, after the in-house production?

Allan Wong: It will be approximately the same as VTech. Of course, if you look at their results four or five years ago, their gross margins even before manufacturing is a lot higher than 28% because they have a lot of software products at that time. However, as tablet sales has come down, so is the software sales, that is one of the reasons why the gross margin also comes down. It is a safe assumption that with in-house manufacturing they will be similar to VTech.

Eric Lau: I see. Thank you.

Ajinkya Dhavale (Fidelity Investments): Yes, thanks a lot. A lot of questions have been answered. Could you give us some idea about the tax implications of the deal because LeapFrog would have a lot of accumulated losses? Can you use that? That is the question. I will come back to the second after you answer. Thanks.

Allan Wong: Okay. Unfortunately, the new tax law does not allow us to use those tax loses that has accumulated in LeapFrog over the years. It is the new tax law that come into effect I think in the 2011-2012 that you are only allowed to use tax loses as a certain percentage of your acquisition price times a certain percentage. The available tax loss that we can use is very small.

Ajinkya Dhavale: Okay. Second question is, I mean, in your opening remarks you said that in the first year, which is FY17, the acquisition will have minimum, some negative impact on your earnings which is obvious. However, I mean, just looking at the numbers, LeapFrog was burning more than $100 million a year. Their operating cost was $160 million last year, and your EBITDA is, I mean, it looks like 40%, 50% of your EBITDA is at risk if the last year cost base continues. You think your cost base reduces so significantly in such a short timeframe?

Allan Wong: Yes. It is a lot of work. Certainly, it is a lot of work. We are able and there are certain restructuring costs associated with the consolidation and with those restructuring we are able to return LeapFrog to the same type of gross margin in 2018 as what VTech is enjoying.

Ajinkya Dhavale: Yeah.

Allan Wong: Because their product costs are no different than VTech's product cost and their ASP and their selling price are similar.

Ajinkya Dhavale: Right.

Allan Wong: We are able to achieve.

Ajinkya Dhavale: Sorry to press a bit here, but their selling and admin cost was $120 million in the last 12 months and their R&D cost is $37 million, so they are spending $150 million a year below gross profit. I mean, that is a lot. That is a very heavy cost base. Compared to your EBITDA of VTech, it is a very large number and you are guiding a quick turnaround or quick cost savings, so I just wanted to… yeah.

Allan Wong: Yes, and I think that is the reason why only VTech is a viable acquirer of LeapFrog. Any other companies are not able to do that because VTech and LeapFrog's businesses are so similar that we are able to very quickly consolidate the sales in our existing operation. Nonetheless, there are certain restructuring costs involved in terms of headcount reduction, in terms of getting rid of certain commitments. It will be all done by 2017.

Ajinkya Dhavale: Right, right.

Allan Wong: That is the reason why we will have some negative contribution because of the restructuring in 2017, but by 2018, we will be able to get the gross margins back to the same level of VTech.

Ajinkya Dhavale: Right. No, my question, even when we exclude the restructuring cost which are obvious, the underlying operating loss of LeapFrog was $130 million plus last 12 months basis. That was more driven by operating cost level, not gross profit margin. I mean, gross profit margins are lower. I understand that. However, I mean, my assessment of the cost base is just too high and you have to cut it by nearly half to achieve a breakeven on 40% to 50% gross profit margin assumption, $200 million of revenue, 40% GP margin gives you $80 million, $90 million of gross profit. Then the $160 million of cost base opex has to fall half to achieve a breakeven. Is that the right thinking on a two-year timeframe?

Allan Wong: Yes, you can actually look at the acquisition on a different angle. Think about acquiring the revenue without adding proportionally a lot of overheads.

Ajinkya Dhavale: Okay.

Allan Wong: That is really the premise that we are looking at because our business and our operations are so similar that for example the logistics, we hardly need to add anything at the logistics. The sales team, we do not need two sales teams. We only need one sales team. In every other country, we do not need two sales offices, the sales subsidiaries. We will only need one. Essentially, we only need to incrementally add certain overheads to our existing overheads.

Ajinkya Dhavale: Understood. Got it.

Allan Wong: Yeah.

Ajinkya Dhavale: Yeah.

Allan Wong: I think the main area that we will increase is on the development side, the educational content development which we think we will benefit from the expertise of the LeapFrog development team. This will give us the ability to come up with better products in the longer term.

Ajinkya Dhavale: Understand, yeah. Right, right. Okay. Can I just question, it is a bit backward-looking and more philosophical question. LeapFrog was running out of cash in next few quarters, if you would not buy them out. Why did we hurry in? I mean, they were losing cash and, I mean, just looking at their financial, it was clear that it goes bankrupt probably in two, three quarters if they continued. Why we hurried in and bought at some premium?

Allan Wong: Yes, I think it is a good question. We have considered this very carefully. One of the options, of course, as you mentioned is, if we do not acquire them, they will go down, well, they will go bankrupt anyway.

Ajinkya Dhavale: Yes, yeah.

Allan Wong: However, when they go bankrupt, the shelf space they have given up does not necessarily comes to VTech.

Ajinkya Dhavale: Okay.

Allan Wong: It will be distributed among others. Then, after they go bankrupt, the brand value of LeapFrog will have eroded so much that it will worth much less.

Ajinkya Dhavale: Okay.

Allan Wong: We made a decision of actually, yes, we pay a bit of premium to buy the business at this point. However, what we are gaining is all the shelf space they are enjoying at this point in time and also the LeapFrog brand equity which is extremely high. They are, in fact, it is public information that the MGA chairman has openly said that the LeapFrog brand is worth a lot more than the $70 million. We decided not to wait for LeapFrog to go bankrupt, but to actually pay a premium in acquiring an ongoing business rather than a bankrupt business.

Ajinkya Dhavale: Okay. Thanks for answering my questions.

Walden Shing (Haitong International): Thank you for taking my questions. I want to ask management about future pricing strategy because if I remember correctly LeapPad used to price at $99.90 while InnoTab is priced at $79.90. After the two companies become one, let's say children's tablets as a product and assume both brands will still be existing in the market, are you going to price both tablets at the same price? Just to get a sense of thinking after you merge the two businesses together.

Another question I want to ask is about the R&D. Both companies currently spend something like $30 million a year on R&D and obviously LeapFrog with much smaller sales, the R&D as a percentage of total revenue is much, much higher. Is there some synergy in this area? I also heard Chairman has been saying you plan to increase your spending on educational and product development, so I want to know a bit more on your thinking about this area. Thank you.

Allan Wong: Certainly when we combine the two companies together, we do not need to fight with each other in terms of these same products. We will do product segmentation so that the VTech brand will not be competing with the LeapFrog brand. Everything that VTech offers will have the unique feature set and then LeapFrog has the unique feature set. Rather than we offer similar products at similar price point. This is a big advantage that we will be happy to streamline our product offering and then come out with products that we are able to expand the market.

As far as R&D spending, as I said earlier, there is a lot of synergies. We are strong in the engineering part, so a lot of the engineering can be done in Hong Kong and China, rather than in the US. However, LeapFrog is very strong in the content development, in the educational team that we can certainly leverage on. There will be a lot of synergies when we combine the two teams together and both we do not need to spend, certainly, the two R&D spending add together because there are synergies. How much savings we can achieve we do not know at this point. However, certainly there are quite a bit of savings.

Walden Shing: Can I have some follow-up questions? Did I get it correctly that let us say in one product type there will be only one product available? They will not be competing offering from VTech and LeapFrog going forward? Am I understanding that correctly?

Allan Wong: Yes. We do not need to. We do not need to have a very similar product competing in the same marketplace. That is correct. We can streamline our products and offer products with different functionality so that we can expand our market share gain together.

Walden Shing: One more question I forgot to ask, when you acquired LeapFrog I think you were acquiring it below book value, so I wonder if your accountant is advising you proforma accounts. Are you going to make some one-off gain because of this negative goodwill stuff?

Allan Wong: No, it is not below book value. Although a lot of their book value is on certain accounting methods that are different from the VTech methods. For example, they capitalise their R&D spending. We do not. When we combine the two together, we will not capitalise those R&D spending. In fact, we have to unwind a lot of their capitalised R&D and that would reduce their book by a substantial amount. It is not a negative goodwill. I know a lot of people have thought the acquired price is below cash value, but in fact it is not.

Walden Shing: Okay, I see. Thank you very much.

Allan Wong: Thank you.

Grace Pang: Thank you. Due to time constraints I am sorry that we need to end the call here. There will be an archive of this webcast beginning at about 8:00 pm Hong Kong time today. Thank you for participating in today's call. Thank you very much.

Allan Wong: Thank you.

[END OF TRANSCRIPT]