JAKKS PACIFIC INC
Form 10-Q
November 07, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission file number: **0-28104**

JAKKS Pacific, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**95-4527222**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
22619 Pacific Coast Highway **Malibu, California**	**90265**
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s telephone number, including area code: **(310) 456-7799**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ý	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No ý

The number of shares outstanding of the issuer’s common stock is 27,521,399 (as of November 6, 2008).

JAKKS PACIFIC, INC. AND SUBSIDIARIES

INDEX TO QUARTERLY REPORT ON FORM 10-Q
Quarter Ended September 30, 2008

ITEMS IN FORM 10-Q

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This report includes “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. For example, statements included in this report regarding our financial position, business strategy and other plans and objectives for future operations, and assumptions and predictions about future product demand, supply, manufacturing, costs, marketing and pricing factors are all forward-looking statements. When we use words like “intend,” “anticipate,” “believe,” “estimate,” “plan” or “expect,” we are making forward-looking statements. We believe that the assumptions and expectations reflected in such forward-looking statements are reasonable and are based on information available to us on the date hereof, but we cannot assure you that these assumptions and expectations will prove to have been correct or that we will take any action that we may presently be planning. We are not undertaking to publicly update or revise any forward-looking statement if we obtain new information or upon the occurrence of future events or otherwise.

1

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	December 31, 2007 (*)	September 30, 2008 (Unaudited)
ASSETS		
Current assets		
Cash and cash equivalents	$ 241,250	$ 192,607
Marketable securities	218	222
Accounts receivable, net of allowances for uncollectible accounts of $1,354 and $1,759, respectively	174,451	230,006
Inventory	75,486	110,829
Prepaid expenses and other current assets	21,733	33,482
Deferred income taxes	13,921	13,297
Total current assets	527,059	580,443
Property and equipment		
Office furniture and equipment	9,961	10,953
Molds and tooling	44,333	59,293
Leasehold improvements	5,186	5,298
Total	59,480	75,544
Less accumulated depreciation and amortization	38,073	48,901
Property and equipment, net	21,407	26,643
Investment in video game joint venture	36,090	40,562
Goodwill, net	353,340	354,993
Trademarks, net	19,568	10,492
Intangibles and other, net	26,200	19,613
Total assets	$ 983,664	$ 1,032,746
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 52,287	$ 111,601
Accrued expenses	70,085	57,282
Reserve for sales returns and allowances	26,036	17,481
Income taxes payable	21,997	1,346
Total current liabilities	170,405	187,710
Deferred income taxes	6,536	6,416
Income tax payable	11,294	11,294
Other liabilities	6,432	2,052
Convertible senior notes	98,000	98,000
Total liabilities	292,667	305,472
Stockholders' equity		
Preferred stock, $.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, $.001 par value; 100,000,000 shares authorized; 28,275,116 and 27,508,505 shares issued and outstanding, respectively	28	28
Additional paid-in capital	312,127	290,010
Retained earnings	382,288	441,466
Accumulated comprehensive loss	(3,446)	(4,230)

Total stockholders’ equity		690,997		727,274
Total liabilities and stockholders’ equity	$	983,664	$	1,032,746

(*) Derived from audited financial statements

See notes to condensed consolidated financial statements.

2

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Three Months Ended September 30, (Unaudited)		Nine Months Ended September 30, (Unaudited)	
	2007	**2008**	**2007**	**2008**
Net sales	$ 318,391	$ 357,824	$ 572,000	$ 634,050
Cost of sales	194,341	228,759	357,147	405,486
Gross profit	124,050	129,065	214,853	228,564
Selling, general and administrative expenses	58,993	62,651	139,985	157,476
Write-down of intangible assets	—	9,076	—	9,076
Income from operations	65,057	57,338	74,868	62,012
Profit from video game joint venture	908	743	3,117	4,470
Interest Income	1,814	709	5,120	2,802
Interest Expense, net of benefit	(692)	2,013	(3,854)	(1,187)
Income before provision for income taxes	67,087	60,803	79,251	68,097
Provision for income taxes	19,979	6,658	23,661	8,919
Net income	$ 47,318	$ 54,145	$ 55,590	$ 59,178
Earnings per share – basic	$ 1.71	$ 2.01	$ 2.01	$ 2.15
Earnings per share – diluted	$ 1.45	$ 1.70	$ 1.75	$ 1.88

See notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30, (Unaudited)	
	2007	**2008**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 55,590	$ 59,178
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	19,831	19,207
Share-based compensation expense	5,206	6,026
Loss on disposal of property and equipment	1,763	51
Write-down of intangible assets	—	9,076
Deferred income taxes	2,169	504
Change in operating assets and liabilities:		
Accounts receivable	(55,940)	(55,555)
Inventory	(16,947)	(35,342)
Prepaid expenses and other current assets	(1,221)	(11,749)
Investment in video game joint venture	(3,631)	(4,801)
Accounts payable	25,422	59,314
Accrued expenses	12,628	1,530
Reserve for sales returns and allowances	(13,125)	(8,555)
Income taxes payable	(2,814)	(20,650)
Other liabilities	1,090	(4,380)
Total adjustments	(25,569)	(45,324)
Net cash provided by operating activities	30,021	13,854
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash paid for net assets acquired, net of cash acquired	(15,605)	(15,193)
Purchase of property and equipment	(13,773)	(17,608)
Purchase of other assets	(222)	143
Net purchase of marketable securities	(6)	(5)
Net cash used by investing activities	(29,606)	(32,663)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from stock options exercised	1,685	960
Common stock repurchased	—	(30,002)
Net cash provided by (used in) financing activities	1,685	(29,042)
Effect of exchange rate changes on cash	—	(792)
Net increase (decrease) in cash and cash equivalents	2,100	(48,643)
Cash and cash equivalents, beginning of period	184,489	241,250
Cash and cash equivalents, end of period	$ 186,589	$ 192,607
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ 23,592	$ 31,719
Interest	$ 2,266	$ 2,342

Non cash investing and financing activity:

In January, March and June 2007, two executive officers surrendered an aggregate of 191,281 shares of restricted stock at a value of $4.7 million to cover their income taxes due on the 2007 vesting of the restricted shares granted them in 2006. This restricted stock was subsequently retired by the Company.

In August 2007, certain employees surrendered an aggregate of 1,200 shares of restricted stock at a value of $19,992 to cover their income taxes due on the 2007 vesting of the restricted shares granted to them.

In January and March 2008, two executive officers surrendered an aggregate of 122,202 shares of restricted stock at a value of $3.0 million to cover their income taxes due on the 2008 vesting of the restricted shares granted to them in 2006, 2007 and 2008. This restricted stock was subsequently retired by the Company.

In July 2008, an employee surrendered 489 shares of restricted stock at a value of $10,484 to cover his income taxes due on the July 1, 2008 vesting of the restricted shares granted to him in 2008.

In August 2008, certain employees surrendered an aggregate of 2,299 shares of restricted stock at a value of $54,854 to cover their income taxes due on the 2008 vesting of the restricted shares granted to them in 2006.

See Notes 8 and 9 for additional supplemental information to the condensed consolidated statements of cash flows.

See notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2008

Note 1 — Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to prevent the information presented from being misleading. These financial statements should be read in conjunction with Management’s Discussion and Analysis of financial condition and results of operations and the financial statements and the notes thereto included in the Company’s Form 10-K, which contains financial information for the three years in the period ended December 31, 2007.

The information provided in this report reflects all adjustments (consisting solely of normal recurring items) that are, in the opinion of management, necessary to present fairly the financial position and the results of operations for the periods presented. Interim results are not necessarily indicative of results to be expected for a full year.

Certain reclassifications have been made to prior year balances in order to conform to the current year presentation.

The condensed consolidated financial statements include the accounts of JAKKS Pacific, Inc. and its wholly-owned subsidiaries (collectively “the Company”).

Note 2 — Business Segments, Geographic Data, Sales by Product Group, and Major Customers

The Company is a worldwide producer and marketer of children’s toys and other consumer products, principally engaged in the design, development, production, marketing and distribution of its diverse portfolio. The Company’s reportable segments are Traditional Toys, Craft/Activity/Writing Products, and Pet Products, each of which includes worldwide sales.

The Traditional Toys segment includes action figures, vehicles, playsets, plush products, dolls, accessories, pretend play products, electronic products, novelty toys, construction toys, compounds, infant and pre-school toys, water toys, kites, squirt guns, and related products.

Craft/Activity/Writing Products include pens, pencils, stationery products and drawing, crayons, markers, paints, and other do-it-yourself related products.

Pet Products include pet toys, treats, apparel and related pet products.

Segment performance is measured at the operating income level. All sales are made to external customers, and general corporate expenses have been attributed to the various segments based on sales volumes. Segment assets are comprised of accounts receivable and inventories, net of applicable reserves and allowances, goodwill and other assets.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 2 — Business Segments, Geographic Data, Sales by Product Group, and Major Customers - (continued)

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts as of December 31, 2007 and September 30, 2008 and for the three and nine months ended September 30, 2007 and 2008 are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Net Sales				
Traditional Toys	$ 299,828	332,395	$ 524,027	$ 583,040
Craft/Activity/Writing Products	12,225	20,616	32,890	37,274
Pet Products	6,338	4,813	15,083	13,736
	$ 318,391	357,824	$ 572,000	$ 634,050

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Operating Income				
Traditional Toys	$ 61,264	$ 53,264	$ 69,913	$ 57,472
Craft/Activity/Writing Products	2,498	3,303	3,319	3,667
Pet Products	1,295	771	1,636	873
	$ 65,057	$ 57,338	$ 74,868	$ 62,012

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Depreciation and Amortization Expense				
Traditional Toys	$ 6,459	$ 6,624	$ 18,830	$ 18,202
Craft/Activity/Writing Products	202	351	623	844
Pet Products	130	26	378	161
	$ 6,791	$ 7,001	$ 19,831	$ 19,207

	December 31, 2007	September 30, 2008
Assets		
Traditional Toys	$ 840,232	$ 874,976
Craft/Activity/Writing Products	115,893	132,448
Pet Products	27,539	25,322
	$ 983,664	$ 1,032,746

The following tables present information about the Company by geographic area as of December 31, 2007 and September 30, 2008 and for the three and nine months ended September 30, 2007 and 2008 (in thousands):

	December 31,	September 30,

	2007	2008
Long-lived Assets		
United States	$ 19,372	$ 25,343
Hong Kong	2,035	1,300
	$ 21,407	$ 26,643

6

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 2 — Business Segments, Geographic Data, Sales by Product Group, and Major Customers - (continued)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2008
Net Sales by Geographic Area				
United States	$ 262,002	$ 280,523	$ 476,492	$ 500,775
Europe	16,295	22,383	29,497	38,825
Canada	12,656	19,495	19,176	28,783
Hong Kong	15,727	15,835	24,543	32,435
Other	11,711	19,588	22,292	33,232
	$ 318,391	$ 357,824	$ 572,000	$ 634,050

Major Customers

Net sales to major customers for the three and nine months ended September 30, 2007 and 2008 were as follows (in thousands, except for percentages):

	Three Months Ended September 30, 2007		Three Months Ended September 30, 2008		Nine Months Ended September 30, 2007		Nine Months Ended September 30, 2008	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	$ 61,981	19.5%	$ 90,733	25.4%	$ 127,852	22.3%	$ 171,670	27.0%
Toys 'R' Us	58,762	18.5	50,612	14.1	87,016	15.2	72,933	11.5
Target	40,843	12.8	29,617	8.3	84,525	14.8	75,234	11.9
	$ 161,586	50.8%	$ 170,962	47.8%	$ 299,393	52.3%	$ 319,837	50.4%

No other customer accounted for more than 10% of the Company's total net sales.

At December 31, 2007 and September 30, 2008, the Company's three largest customers accounted for approximately 82.2% and 55.4%, respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

Note 3 — Inventory

Inventory, which includes the ex-factory cost of goods, in-bound freight, duty and warehouse costs, is stated at the lower of cost (first-in, first-out) or market and consists of the following (in thousands):

	December 31, 2007	September 30, 2008

Raw materials	$	1,694	$	7,024
Finished goods		73,792		103,805
	$	75,486	$	110,829

7

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 4 — Revenue Recognition and Reserve for Sales Returns and Allowances

Revenue is recognized upon the shipment of goods to customers or their agents, depending on terms, provided that there are no uncertainties regarding customer acceptance, the sales price is fixed or determinable, and collectability is reasonably assured and not contingent upon resale.

Generally, the Company does not allow for product returns. It provides a negotiated allowance for breakage or defects to its customers, which is recorded when the related revenue is recognized. However, the Company does make occasional exceptions to this policy and consequently accrues a return allowance in gross sales based on historic return amounts and management estimates. The Company also will occasionally grant credits to facilitate markdowns and sales of slow moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence.

The Company also participates in cooperative advertising arrangements with some customers, whereby it allows a discount from invoiced product amounts in exchange for customer purchased advertising that features the Company’s products. Typically, these discounts range from 1% to 6% of gross sales, and are generally based on product purchases or on specific advertising campaigns. Such amounts are accrued when the related revenue is recognized or when the advertising campaign is initiated. These cooperative advertising arrangements are accounted for as direct selling expenses.

The Company’s reserve for sales returns and allowances amounted to $26.0 million as of December 31, 2007, compared to $17.5 million as of September 30, 2008. This decrease was due primarily to certain customers taking their year-end allowances related to 2007 and 2008 during 2008.

Note 5 — Convertible Senior Notes

In June 2003, the Company sold an aggregate of $98.0 million of 4.625% Convertible Senior Notes due June 15, 2023 and received net proceeds of approximately $94.4 million. The notes are convertible into shares of the Company’s common stock at an initial conversion price of $20.00 per share, or 50 shares per note, subject to certain circumstances. The notes may be converted in each quarter subsequent to any quarter in which the closing price of the Company’s common stock is at or above a prescribed price for at least 20 trading days in the last 30 trading day period of the quarter. The prescribed price for the conversion trigger is $24.00 through June 30, 2010, and increases nominally each quarter thereafter. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, the Company will redeem the notes at their accreted principal amount, which will be equal to $1,811.95 (181.195%) per $1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of September 30, 2008 and are convertible during the fourth quarter of 2008.

The Company may redeem the notes at its option in whole or in part beginning on June 15, 2010, at 100% of their accreted principal amount plus accrued and unpaid interest, if any, payable in cash. Holders of the notes may also require the Company to repurchase all or part of their notes on June 15, 2010, for cash, at a repurchase price of 100% of the principal amount per note plus accrued and unpaid interest, if any. Holders of the notes may also require the Company to repurchase all or part of their notes on June 15, 2013 and June 15, 2018 at a repurchase price of 100% of the accreted principal amount per note plus accrued and unpaid interest, if any, and may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 6 — Income Taxes

Provision for income taxes includes Federal, state and foreign income taxes at effective tax rates of 29.9% and 13.1%, respectively for the nine months ended September 30, 2007 and 2008. The effective tax rate benefits from a tax rate of 17.5% and 16.5% for 2007 and 2008, respectively, on the Company’s income arising in, or derived from, Hong Kong. The decrease in the effective rate in 2008 is primarily due to the recognition of certain discrete income tax adjustments recognized in the quarter ended September 30, 2008 and a change in the federal tax code which reduced the amount of foreign income includible on the federal income tax return. These discrete adjustments included the reconciliation of the 2007 income tax provision to the actual income tax liability as reflected in the Company’s income tax return in the amount of $4.0 million, and the reduction in income tax expense due to the derecognition of a previously recorded potential income tax liability for uncertain tax positions that are no longer subject to audit due to the closure of the audit period in the amount of $9.3 million. Absent these discrete items, the effective tax rate would be 32.0% in 2007, and 32.6% in 2008. As of September 30, 2008, the Company had net deferred tax assets of approximately $6.9 million for which an allowance of $0.9 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

Current interest on income tax liabilities is recognized as interest expense and penalties on income tax liabilities are recognized as other expense in the consolidated statement of operations. During the nine months ended September 30, 2008, the Company reversed $1.4 million of net current year interest expense and reversed an additional $1.7 million of non-current interest liability, relating to uncertain tax positions in tax year 2004, which is no longer subject to audit by the Internal Revenue Service.

Approximately $9.3 million of United States based unrecognized tax benefits were recognized in the quarter ended September 30, 2008. The tax years 2002 through 2007 are still subject to examination in Hong Kong. Tax years 2005 through 2007 are still subject to examination in the United States and tax years 2003 through 2007 are still subject to examination in California. The U.S. Internal Revenue Service has recently commenced an examination related to the 2005 U.S. federal income tax return. The ultimate resolution of the U.S. examination, including matters that may be resolved within the next twelve months, is not yet determinable.

Note 7 — Earnings Per Share

The following table is a reconciliation of the weighted average shares used in the computation of basic and diluted earnings per share for the periods presented (in thousands, except per share data):

	Three Months Ended September 30,					
	2007			2008		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share
Earnings per share - basic						
Income available to common stockholders	$ 47,318	27,733	$ 1.71	$ 54,145	26,981	$ 2.01
Effect of dilutive securities:						

Convertible senior notes	737	4,900		737	4,900	
Options and warrants	—	260		—	119	
Unvested restricted stock grants	—	252		—	257	
Earnings per share - diluted						
Income available to common stockholders plus assumed exercises and conversion	$ 48,055	33,145	$ 1.45	$ 54,882	32,257	$ 1.70

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 7 — Earnings Per Share (continued)

	Nine Months Ended September 30,					
	2007			2008		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share