Entertainment & Leisure
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COMPANY UPDATE / ESTIMATE CHANGE

JAKKS Pacific, Inc.

JAKK — NASDAQ — Neutral-4

4Q Results Beat Low Expectations; We Expect Improvements in 2017

Key Metrics		
JAKK - NASDAQ (as of 2/23/17)		$5.70
Price Target		N/A
52-Week Range		$4.63 - $9.75
Shares Outstanding (mil.) (basic)		16.1
Market Cap. ($ mil.)		$92
3-Mo. Average Daily Volume		384,360
Institutional Ownership		98%
Total Debt/Total Capital (12/16)		61%
ROE (TTM ended 12/16)		N/A
Book Value/Share (12/16)		$8.40
Price/Book Value		0.7x
Annual Dividend & Yield	Nil	Nil
EBITDA Margin (TTM Ended 12/16)		5.9%

EPS FY 12/31 (GAAP figures)

	2015	2016	Prior 2017E	Curr. 2017E
1Q	($0.40)	($1.01)		
2Q	($0.30)	($0.27)		
3Q	$1.12	$0.82		
4Q	($0.50)	($0.47)		
Year	$0.71	$0.07	$0.45	$0.37
P/E	8.0x	N/A		15.4x

Note: Quarterly EPS figures may not add to annual total due to impact of quarterly net losses, and the treatment of convertible securities and the related impact on share count.

Net Sales ($mm)

	2015	2016	Prior 2017E	Curr. 2017E
1Q	$114	$96		
2Q	$131	$141		
3Q	$337	$303		
4Q	$163	$167		
Year	$746	$707	$750	$690

Company Description: *JAKKS Pacific, Inc. is a designer and marketer of toys and consumer products, many of which are based on popular entertainment property licenses. Proprietary brands include JAKKS Pacific, Road Champs, Funnoodle, miWorld, Kids Only, Tollytots, Disguise, Maui, Moose Mountain, and TV Games. Additionally, the company is a joint venture partner in DreamPlay Toys, which focuses on digital initiatives and utilizes proprietary image recognition technology.*

Investment Highlights

- **4Q results were above recently reduced expectations.** Management lowered 2016 guidance in December based on industry conditions and company performance. In hindsight, this guidance may have been conservative (which we appreciate), as key metrics of sales and adjusted EBITDA (earnings before interest, taxes, depreciation & amortization) exceeded expectations for the quarter, pushing annual figures ahead of guidance.
- **4Q sales were $167 million, up slightly versus a year ago compared to our expectation of a slight decline.** Margins improved due to cost containment, and adjusted EBITDA increased to $4.0 million from a negative $2.1 million in 4Q of the previous year. The net loss per share was $0.47, a bit below a net loss of $0.50 a year ago.
- **The balance sheet has gone through some changes.** In late 2016 and early 2017, the company repurchased or exchanged various amounts of a convertible note issue, which led to a lower cash balance but also lower annualized interest expense.
- **We have updated our 2017 outlook.** We have reduced our annual sales estimate based on management's simplistic expectation of "lower sales" for the year. A key factor in that outlook is a conservative view of the toy retailing landscape, particularly given some order weakness and high inventories at year-end 2016. Margins and net profits are expected to be higher.
- **We prefer the investment sidelines at this time.** Despite expected improvements in 2017, we find JAKK shares fairly valued given industry challenges and elusive top-line growth at the company. We will continue to monitor the industry environment and the company's growth ambitions, searching for an attractive risk/reward condition. Our Suitability rating remains 4, which reflects the earnings history, seasonality, market capitalization, and the overall debt level.

Note Important Disclosures on Pages 5-6.
Note Analyst Certification on Page 5.

Exhibit 1
Income Statement Highlights (figures in thousands except percentages and per share data)

	Three Months Ended			Year Ended		
	12/31/16	**12/31/15**	**% chg.**	**12/31/16**	**12/31/15**	**% chg.**
Net Sales	$167,026	$163,407	2.2%	$706,603	$745,741	(5.2%)
Gross Profit	$52,105	$49,575	5.1%	$223,021	$228,569	(2.4%)
Adjusted EBITDA	$4,023	($2,143)	NMF	$41,671	$50,949	(18.2%)
Operating Income	($2,391)	($6,891)	(65.3%)	$17,106	$30,530	(44.0%)
Net Income	($7,752)	($9,386)	(17.4%)	$1,249	$23,170	(94.6%)
GAAP EPS, diluted	($0.47)	($0.50)	(6.0%)	$0.07	$0.71	(90.1%)
Diluted Shares Outst.	16,098	18,781	(14.3%)	16,665	43,321	(61.5%)
As a % of Net Sales:			**bp chg.**			**bp chg.**
Gross Profit	31.20%	30.34%	86	31.56%	30.65%	91
Adjusted EBITDA	2.41%	NMF	NMF	5.90%	6.83%	(93)
Operating Income	NMF	NMF	NMF	2.42%	4.09%	(167)
Net Income	NMF	NMF	NMF	0.18%	3.11%	(293)

EBITDA = earnings before interest, taxes, depreciation & amortization
Adjusted EBITDA excludes nonrecurring charges such as reorganization expenses and various non-cash items.
Diluted EPS calculation in 4Q of both years and full year 2016 assumes no conversion of convertible note.

Source: JAKKS Pacific, Inc.

Additional comments 2016 results. On Friday, December 16, after the market close, JAKKS issued a press release in which it lowered financial guidance for the 2016 annual period. Reaction in the market on Monday, December 19, was quite negative (closing price down 33% on heavy volume) as street earnings estimates and investment ratings were lowered. The revised outlook reflected lower than expected sales of select key product lines. For all of 2016, net sales were expected at $700 million, adjusted EBITDA was projected at $37 million, and diluted earnings per share was expected in the range of $0.01-$0.05. Actual full year results included net sales of $707 million, adjusted EBITDA of roughly $42 million, and diluted EPS of $0.07.

The year's sales were spread out among all of the company's segments, including internally owned intellectual property and licensed products. The *Disney Princess* doll line and merchandise based on Disney's *Frozen* franchise remained vital contributors. Annual gross margin improved as a result of concentrated efforts to boost that figure. Still, it was a difficult year for JAKKS, with net losses in three of the quarters (granted, not too unusual considering the seasonality in the business) and a profit decline in the most important quarter (3Q, representing holiday-related business).

We believe one positive factor during the year was the company's reaction to industry sluggishness, weak earnings, and perhaps an underperforming stock (JAKK down 35% in calendar 2016 versus a 10% gain for the S&P 500). This includes putting a higher priority on cost-cutting, adding new products, forging new business relationships, and making financial adjustments that included a focus on shoring up the balance sheet and becoming more conservative with financial guidance.

Financial condition. Long-term debt at December 31, 2016 amounted to $203.0 million. This reflects two convertible notes— a 4.25% issue due in 2018 and a 4.875% issue due in 2020. During the quarter, the company repurchased $5.4 million of the 2018 note, which resulted in a reduction in the number of common shares underlying the notes by 622,000 shares. At quarter end, total debt (including some modest short-term debt) represented approximately 61% of total capitalization. Accounts receivable and inventory both increased from one year ago. Shareholders' equity was $135.2 million.

Thus far in the current quarter (1Q of 2017), the company entered into exchange transactions with holders of the 2018 convertible note, which included an exchange of $39.1 million of the notes for 2.9 million JAKK common shares and $24.1 million in cash. This reduced the principal balance of the notes to $54.7 million, reduced the number of shares underlying the notes by 1.6 million, and reduced annualized interest expense by $1.7 million. Our 2017 financial outlook, as noted in Exhibit 2, reflects these transactions.

Update on Frozen movie sequel. We have not assumed a full-length sequel to the original *Frozen* movie (released November 2013) in our model. Disney has confirmed such a project is in development, but has not discussed it when speaking about its 2017 and 2018 film pipeline. We feel the eventual release of a *Frozen* sequel could result in a meaningful jump in JAKKS' doll and toy sales, as it did in the years following the film's original release. We currently believe the most likely time frame for a sequel is 2019, one year later than our previous assumption. Eventual confirmation of a *Frozen* sequel release date could lead to some fine-tuning of our financial model.

Valuation. The price/earnings multiple on our 2017 earnings estimate of $0.37 per share is 15.4x. A small applicable peer group comprised of the industry's two main large-cap competitors (Mattel and Hasbro) is trading at an average of 19x the consensus 2017 earnings estimate. As for major market indices, the S&P 500 is trading at 18x estimated 2017 earnings, and the S&P Consumer Discretionary sector is also trading at 20x. Finally, the NASDAQ Composite is trading at 22x. We believe some valuation discount for JAKKS is likely warranted due to the company's small size and history of uneven operating results including past annual net losses (2012-2013, for example).

Enterprise value divided by EBITDA is a frequently cited valuation for various Consumer Discretionary companies, including some toy companies. This calculation focuses on the implied total value of a company (market capitalization plus net debt) relative to cash flow. We have not used this metric often in analyzing JAKK given historical low levels of interest expense. However, with recent convertible note issues along with the presence of depreciation & amortization, we believe this valuation measure has become more meaningful. Based on the recent stock price, Enterprise Value represented just under 5x our 2017 adjusted EBITDA estimate. This assumes conversion of the convertible securities and uses a fully diluted share count of approximately 37.5 million.

Opinion. We continue to believe the company has some work to do in building its product portfolio and integrating several small, recent acquisitions. In addition, it may need to earn investors' confidence by producing several quarters of sales and earnings that meet or beat expectations before stock valuations can meaningfully expand, in our view.

Despite the low absolute stock price and seemingly low valuations, we prefer the sidelines at this time as we closely monitor additions to the product portfolio, the progression of quarterly operating results, industry conditions, and perhaps most importantly, stock valuation. Should we consider the risk/reward relationship to be favorable at some point, we would consider a purchase recommendation on JAKK. For now, we remain Neutral.

Suitability. Our Suitability rating of 4 reflects past earnings volatility, extreme seasonality whereby the bulk of annual profits come from one quarter (September), recent changes in the company's consumer product licenses, a small market capitalization, and a relatively mature industry.

Risks. Factors that could impact the share price include toy safety issues, weakening of the domestic retailing environment, the impact of geopolitical events on international sales potential, competitive threats to current popular products, tepid consumer reaction to future products, and risks associated with acquiring and integrating businesses.

Also, we note that Dr. Patrick Soon-Shiong, founder of NantWorks, LLC (JAKKS' joint venture partner in DreamPlay Toys), and related entities recently held an estimated 15% equity stake in JAKKS Pacific through ownership of common stock and convertible notes.

Exhibit 2

GAAP-based Consolidated Statements of Income (figures in thousands except percentages and per share data)

	2017E	% chg.	2016	% chg.	2015	% chg.	2014	% chg.
Net Sales	$690,000	(2.3%)	$706,603	(5.2%)	$745,741	(7.9%)	$810,060	28.0%
Cost of Goods	363,500	(2.7%)	373,610	(7.6%)	404,132	(11.3%)	455,756	19.6%
Royalty Expense	94,000	(4.0%)	97,904	(5.4%)	103,484	(5.4%)	109,406	26.7%
Amort. Of Tools & Molds	12,100	0.3%	12,068	26.3%	9,556	5.1%	9,091	(7.6%)
Gross Profit	220,400	(1.2%)	223,021	(2.4%)	228,569	(3.1%)	235,807	51.4%
Direct Selling Exp.	62,000	(5.8%)	65,797	11.4%	59,090	(11.2%)	66,525	46.8%
SG&A	128,000	(1.0%)	129,242	(0.3%)	129,645	2.1%	126,921	(8.3%)
Reorganization Exp.	0		0		0		1,154	
Depreciation & Amort.	11,000	1.1%	10,876	16.9%	9,304	(5.8%)	9,880	(14.6%)
Operating Income	19,400	13.4%	17,106	(44.0%)	30,530	(2.5%)	31,327	NM
Income from Jt. Venture ~	500		889		2,761		314	
Other Items (Exp.)	0		305		5,642		5,932	
Net Interest Inc. (Exp.)	(10,500)	(18.8%)	(12,924)	4.7%	(12,340)	(0.1%)	(12,349)	28.4%
Income Before Taxes	9,400	74.9%	5,376	(79.8%)	26,593	5.4%	25,224	NM
Taxes	1,786	(56.7%)	4,127	20.6%	3,423	(7.9%)	3,715	NM
Net Income	$7,614	509.6%	$1,249	(94.6%)	$23,170	7.7%	$21,509	NM
N.I. Attrib. to non-control. int.	0		6		(84)			
N.I. Attrib. to JAKKS	$7,614	512.6%	$1,243	(94.7%)	$23,254			
GAAP-based EPS	**$0.37**	392.4%	**$0.07**	(89.4%)	**$0.71**	0.8%	**$0.70**	NM
Diluted Shares Outst. *	37,500	125.0%	16,665	(61.5%)	43,321	4.3%	41,516	87.0%
Adjusted EBITDA	$45,000	8.0%	$41,671	(18.2%)	$50,949	(3.7%)	$52,925	NM
As a % of Net Sales:								
Gross Profit	31.94%		31.56%		30.65%		29.11%	
Direct Selling Exp.	8.99%		9.31%		7.92%		8.21%	
SG&A	18.55%		18.29%		17.38%		15.67%	
Adjusted EBITDA	6.52%		5.90%		6.83%		6.53%	
Operating Income	2.81%		2.42%		4.09%		3.87%	
Net Income	1.10%		0.18%		3.11%		2.66%	
Tax Rate	19.00%		76.77%		12.87%		14.73%	

* Share count and EPS calculations assume conversion of convertible securities in years when profit threshold is met (2017E, 2015, 2014), thus requiring use of fully diluted shares under the "if converted" calculation method. In years of modest profit or a net loss (2016), no conversion is assumed.

Note: Expense figures include stock-based compensation charges and legal/advisory expenses.

Source: JAKKS Pacific, Inc. and Hilliard Lyons estimates — Note: December fiscal year

Additional information is available upon request.

Prices of other stocks mentioned: The Walt Disney Co. - DIS - $109.73 - LT Buy
Mattel Inc. - MAT - $25.53
Hasbro Inc. - HAS - $97.05

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings
1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	36	30%	17%	83%
Hold/Neutral	76	62%	7%	93%
Sell	10	8%	0%	100%

As of 6 February 2017

Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

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