Entertainment & Leisure
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COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics		
JAKK - NASDAQ (as of 7/24/17)		$3.75
Price Target		N/A
52-Week Range		$3.60 - $9.75
Shares Outstanding (mil.) (basic)		21.6
Market Cap. ($ mil.)		$81
3-Mo. Average Daily Volume		197,960
Institutional Ownership		84%
Total Debt/Total Capital (6/17)		52%
ROE (TTM ended 6/17)		N/A
Book Value/Share (6/17)		$6.43
Price/Book Value		0.6x
Annual Dividend & Yield	Nil	Nil
EBITDA Margin (TTM Ended 6/17)		4.5%

EPS FY 12/31 (GAAP figures)

	2016	Prior 2017E	Curr. 2017E		Prior 2018E	Curr. 2018E
1Q	($1.01)		($1.01)	A		
2Q	($0.27)		($0.77)	A		
3Q	$0.82		$0.80			
4Q	($0.47)		$0.08			
Year	$0.07	$0.34	$0.15			$0.30
P/E	53.6x		25.0x			12.5x

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)

	2016	Prior 2017E	Curr. 2017E		Prior 2018E	Curr. 2018E
1Q	$96		$95	A		
2Q	$141		$120	A		
3Q	$303		$300			
4Q	$167		$165			
Year	$707	$685	$680			$695

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.*

JAKKS Pacific, Inc.

JAKK — NASDAQ — Neutral-4

2Q Loss Wider Than Year Ago; Management Still Believes in 2H Turnaround

Investment Highlights

- **JAKK reported lower 2Q results.** Net sales declined 15% from the year ago period to $119.5 million. Gross margin declined and the SG&A ratio rose. Adjusted EBITDA (earnings before interest, taxes, depreciation & amortization, excluding restricted stock compensation expense) swung to a negative $5.3 million compared to a positive $4.0 million a year ago. The net loss per share of $0.77 was wider than the net loss of $0.27 a year ago. The company had not given financial guidance for the quarter, but we expected more favorable numbers.
- **The balance sheet deserves close monitoring, in our view.** In late 2016 and thus far in 2017, the company repurchased or exchanged various amounts of a convertible note due August 2018, which has led to lower cash balances but lower annual interest expense. The company may continue chipping away at the remaining $43 million of the issue or explore refinancing options. JAKKS has another convertible note in the amount of $113 million due June 2020.
- **We have updated our financial estimates.** We still expect 2017 sales to be lower than in 2016. This reflects management's guidance (directional only) and our views of the toy retailing landscape and the company's product lines. We expect annual net income, EPS, and adjusted EBITDA to be higher than last year.
- **We maintain our Neutral rating.** Although we expect operational improvements in 2H of this year, industry challenges (mature nature and conservative ordering trends from retail) and elusive top-line growth at the company keep us on the sidelines for now. We will continue to monitor the industry environment and the company's progress on its strategies, and await more attractive risk/reward conditions. Our Suitability rating of 4 reflects the company's earnings history, market capitalization, and balance sheet, among other factors.

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			Six Months Ended		
	06/30/17	06/30/16	% chg.	06/30/17	06/30/16	% chg.
Net Sales	$119,565	$140,977	(15.2%)	$214,070	$236,786	(9.6%)
Gross Profit	$33,719	$44,800	(24.7%)	$63,740	$75,983	(16.1%)
Adjusted EBITDA	($5,357)	$4,017	N/A	($15,954)	($5,140)	210.4%
Operating Income	($14,108)	($1,100)	1182.5%	($29,832)	($14,916)	100.0%
Net Income	($16,742)	($4,369)	283.2%	($35,058)	($21,784)	60.9%
GAAP EPS, diluted	($0.77)	($0.27)	185.2%	($1.77)	($1.30)	36.2%
Diluted Shares Outst.	21,616	16,402	31.8%	19,865	16,818	18.1%
As a % of Net Sales:			bp chg.			bp chg.
Gross Profit	28.20%	31.78%	(358)	29.78%	32.09%	(231)
Adjusted EBITDA	N/A	2.85%		N/A	N/A	
Operating Income	N/A	N/A		N/A	N/A	
Net Income	N/A	N/A		N/A	N/A	

Diluted EPS calculations in all presented periods assume no conversion of convertible note.

Source: JAKKS Pacific, Inc.

Additional comments on 2Q results. Top line contributions came from product lines based on various Disney properties such as *Beauty and the Beast*, *Moana*, and *Disney Princess*, as well licensed products based on brands such as *Nintendo* and others. Sales of *Frozen* merchandise (primarily dolls) were below the year ago level. Gross margin declined over 350 basis points due to the sales decline, the product mix, and higher amortization of tools and molds. SG&A expenses were roughly flat but the expense ratio rose due to the lower sales base. Adjusted EBITDA and net income both declined from year ago figures.

Financial condition. The June 30, 2017 cash balance was $64.1 million. The company's primary debt consists of two convertible notes— a 4.25% issue due August 2018 and a 4.875% issue due June 2020. Following several transactions over the past year or so in which the company repurchased or exchanged some of the 2018 notes for JAKK common shares and cash, the remaining principal amount of the two notes was roughly $156 million at June 30, 2017. Management continues to focus on the August 2018 maturity. We believe this could include further exchanges/repurchases or refinancing options. At quarter end, total debt represented approximately 52% of total capitalization. The accounts receivable balance was down due to lower shipments, while inventory was up. Shareholders' equity was $138.9 million.

Outlook. We have updated our financial model to reflect recent results and the 2H outlook. This includes reductions for our 2017 sales and profit forecast. Our annual outlook requires an earnings rebound in the remaining six months of 2017, which could occur due to expected lower operating expenses compared to last year, ongoing cost containment initiatives, and some new product launches. One variable that could affect business late this year is a planned 22-minute animated short from Disney based on the highly popular *Frozen* franchise. This franchise has been a major driver for JAKKS and its related doll/toy lines, which are now generating year-over-year sales declines based on tough comparisons and the age of the property (film debuted in November 2013). Although a full-length sequel to *Frozen* is not expected until November 2019, we believe this relatively short content release could help near-term product sales.

We have also initiated 2018 estimates, including projected increases in sales (up 2%) and earnings per share (doubling our 2017 estimate). We assume gross margin improvement and lower interest expense given past exchanges/redemptions of the 2018 convertible issue and its scheduled August maturity. We have tried to make conservative assumptions regarding the industry environment given recent sluggishness and trends toward online shopping (less store traffic).

Valuation. The price/earnings multiple on our 2017 earnings estimate of $0.15 per share is 25.0x, while the multiple on our 2018 estimate is 12.5x. This translates into an approximate 18-19x multiple on our estimate of twelve-month forward earnings. A small applicable peer group comprised of the industry's two main large-cap competitors (Mattel and Hasbro) is trading at an average of roughly 22x estimated forward earnings. As for comparable market indices, the S&P 500 is trading at just under 20x estimated 2017 earnings and the S&P Consumer Discretionary sector is trading at just under 20x as well. We believe some valuation discount for JAKKS is likely warranted due to the company's small size, history of uneven operating results, including past annual net losses (2012-2013, for example), and the current capital structure.

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 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 about 4x our estimate of forward adjusted EBITDA. This assumes non-conversion of the convertible securities.

Opinion. We continue to believe the company has work to do in building its product portfolio. This includes maintaining the productivity of its evergreen products/franchises, launching new desirable proprietary products (including output from an animation joint venture), and integrating recently acquired products. The company also plans to enter new product categories and geographies (with several new international sales offices) and expand relationships with online retailers.

From an investment viewpoint, we believe management will need to address the convertible securities, particularly the 2018 maturity, in the most investor-friendly manner possible. Also, the company may need to earn investors' confidence by producing several quarters of sales and profits that meet or beat expectations before stock valuations can meaningfully expand, in our view.

Despite the low absolute stock price, we prefer the sidelines at this time as we closely monitor the product portfolio, the progression of quarterly operating results, industry conditions, and the capital structure. We believe patience and close monitoring of the stock and the business is most prudent at this time. Should we consider the risk/reward relationship to be more 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), a small market capitalization, upcoming debt maturities, 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.

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. Given the approximate 20% equity stake recently held by Hong Kong Meisheng Culture Company Ltd (another joint venture partner of JAKKS), a significant degree of ownership in JAKKS Pacific is held by these two partners of the company.

Exhibit 2

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

	2018E	% chg.	2017E	% chg.	2016	% chg.	2015	% chg.
Net Sales	$695,000	2.2%	$680,000	(3.8%)	$706,603	(5.2%)	$745,741	(7.9%)
Cost of Goods	365,000	1.4%	360,000	(3.6%)	373,610	(7.6%)	404,132	(11.3%)
Royalty Expense	94,000	1.1%	93,000	(5.0%)	97,904	(5.4%)	103,484	(5.4%)
Amort. Of Tools & Molds	12,250	(2.0%)	12,500	3.6%	12,068	26.3%	9,556	5.1%
Gross Profit	223,750	4.3%	214,500	(3.8%)	223,021	(2.4%)	228,569	(3.1%)
Direct Selling Exp.	65,000	3.2%	63,000	(4.3%)	65,797	11.4%	59,090	(11.2%)
SG&A	128,000	1.6%	126,000	(2.5%)	129,242	(0.3%)	129,645	2.1%
Reorganization Exp.	0		0		0		0	
Depreciation & Amort.	11,250	2.3%	11,000	1.1%	10,876	16.9%	9,304	(5.8%)
Operating Income	19,500	34.5%	14,500	(15.2%)	17,106	(44.0%)	30,530	(2.5%)
Income from Jt. Venture ~	400		500		889		2,761	
Other Items (Exp.)	0		0		305		5,642	
Net Interest Inc. (Exp.)	(9,500)	(2.6%)	(9,750)	(24.6%)	(12,924)	4.7%	(12,340)	(0.1%)
Income Before Taxes	10,400	98.1%	5,250	(2.3%)	5,376	(79.8%)	26,593	5.4%
Taxes	4,160	98.1%	2,100	(49.1%)	4,127	20.6%	3,423	(7.9%)
Net Income	$6,240	98.1%	$3,150	152.2%	$1,249	(94.6%)	$23,170	7.7%
N.I. Attrib. to non-control. int.	5		4		6		(84)	
N.I. Attrib. to JAKKS	$6,235	98.2%	$3,146	153.1%	$1,243	(94.7%)	$23,254	
GAAP-based EPS	**$0.30**	102.2%	**$0.15**	96.8%	**$0.07**	(89.4%)	**$0.71**	0.8%
Diluted Shares Outst. *	33,000	54.5%	21,360	28.2%	16,665	(61.5%)	43,321	4.3%
Adjusted EBITDA	$45,000	7.1%	$42,000	0.8%	$41,671	(18.2%)	$50,949	(3.7%)
As a % of Net Sales:								
Gross Profit	32.19%		31.54%		31.56%		30.65%	
Direct Selling Exp.	9.35%		9.26%		9.31%		7.92%	
SG&A	18.42%		18.53%		18.29%		17.38%	
Adjusted EBITDA	6.47%		6.18%		5.90%		6.83%	
Operating Income	2.81%		2.13%		2.42%		4.09%	
Net Income	0.90%		0.46%		0.18%		3.11%	
Tax Rate	40.00%		40.00%		76.77%		12.87%	

* Share count and EPS calculations assume conversion of convertible securities in years when profit threshold is met (2018E, 2015), thus requiring use of fully diluted shares under the "if converted" calculation method. In years of modest profit or a net loss (2017E, 2016), no conversion is assumed.

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

Note: Fiscal 2018 estimated figures reflect August 2018 maturity of a convertible note.

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 - $107.00 - LT Buy Mattel Inc. - MAT - $20.80 Hasbro Inc. - HAS - $105.00 Nintendo Co. Ltd. - NTDOY - $40.825

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	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 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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