

Half-year report 2004



**Zapp**  
creation

# At a Glance

## Consolidated Key Figures

	Q2/2004	Q2/2003	H1/2004	H1/2003	H1 +/- in % <sup>1)</sup>
<b>Income Statement</b>					
Net sales in K€	30,577	30,922	49,712	60,014	- 17
EBITDA in K€	4,256	4,304	3,792	8,027	- 53
EBIT in K€	2,513	2,662	446	4,793	- 91
Net income in K€	1,198	1,718	- 629	2,769	n/a
Basic earnings per share in €	0.16	0.22	- 0.08	0.35	n/a
<b>Balance sheet</b>					
Total assets as of June 30 in K€	n/a	n/a	142,041	129,137	10
Investments in K€	1,647	1,886	3,309	4,582	- 28
<b>Cash flow</b>					
Net cash flow per share in €	- 2.23	- 1.00	- 2.71	- 0.61	n/a
<b>Stock</b>					
Stock price, high (Xetra) in €	21.74 (April 19)	35.20 (May 16)	23.79 (Feb. 18)	35.20 (May 16)	n/a
Stock price, low (Xetra) in €	17.10 (June 1)	27.45 (April 1)	17.10 (June 1)	24.02 (Mar. 11)	n/a
Stock price, end of quarter (Xetra) in €	19.35	32.40	19.35	32.40	- 40
Stock price, average (Xetra) in €	19.14	32.15	20.38	29.18	- 30
Average daily trading volume (Xetra, number of shares)	30,559	27,990	38,226	22,017	74
Market capitalization (base: end of quarter) in € million	155	259	155	259	- 40
Number of employees at the closing date (June 30) <sup>2)</sup>	484	529	484	529	- 9

<sup>1)</sup> rounded

<sup>2)</sup> not including management board and trainees

# Report for the first half-year 2004

- **Second-quarter sales of EUR 30.6 million stabilize at previous year's level**
- **EBIT of EUR 0.4 million turns positive at the half-year mark**
- **Gross margin at 57 percent after the first six months**

Recording sales of EUR 30.6 million, Zapf Creation AG was able to stabilize revenues almost at the previous year's level. Due to the weak first quarter, in which sales came in at just EUR 19.1 million, sales for the first six months were EUR 49.7 million (adjusted for currency effects: EUR 50.5 million), down from the previous year's figure of EUR 60.0 million. At EUR 2.5 million, earnings before interest and taxes (EBIT) in the second quarter more than compensated for the first-quarter loss, resulting in a positive EBIT of EUR 0.4 million for the first half of the year. After increased logistics expenses had negatively impacted the gross margin in the first quarter, it developed according to plan in Q2/2004 and was just under 57 percent at the half-year mark. Net income for the first six months was minus EUR 0.6 million, earnings per share were minus EUR 0.08.

The net cash used for operating activities increased from EUR 4.8 million to EUR 20.1 million, primarily because of declining payments received due to two weak quarters in a row (Q4/2003 and Q1/2004). Figures for the first six months of 2003 were boosted by an extraordinarily high volume of payments received from the strong fourth quarter of fiscal year 2002. Based on current plans, the company expects a positive operating cash flow in the double-digit millions for fiscal year 2004.

The net debt increased considerably from EUR 43.3 million to more than EUR 70.1 million, as had to expected following two consecutive weak quarters with a significantly lower volume of payments received. Just over one third of the increase in liabilities to banks was the result of the purchase of treasury stock in the fourth quarter of 2003 to back the existing stock option plans.

## The American market and Great Britain/Ireland record growth in local currency terms

Central Europe recorded half-year sales of EUR 18.1 million, down 35 percent from the previous year. This development is primarily due to large inventories among German retailers at the beginning of the year. At the end of June 2004, however, retailers had reduced these inventories satisfactorily. Sell-through of Zapf Creation's play and functional dolls including accessories in Germany was 2 percent higher than during the same period of last year although the German play and functional doll market declined by 2.5 percent in the first six months of this year (Source: NPD/Eurotoys). In Germany, sales momentum was also provided by the successful launch of the New BABY born® in the second quarter.

### Breakdown of sales by business units

	H1/2004	H1/2003	+/-
	K€	K€	in %
<b>Europe</b>	<b>38,495</b>	<b>48,770</b>	<b>- 21</b>
Central Europe	18,112	27,676	- 35
Northern Europe	12,612	13,395	- 6
Southern Europe	5,875	6,494	- 10
Eastern Europe	1,896	1,205	57
<b>The Americas</b>	<b>8,212</b>	<b>8,568</b>	<b>- 4</b>
<b>Asia/Australia</b>	<b>3,005</b>	<b>2,676</b>	<b>12</b>
<b>Net sales</b>	<b>49,712</b>	<b>60,014</b>	<b>- 17</b>

In the Northern Europe operating business unit, Great Britain/Ireland showed growth of 16 percent in local currency terms and even 18 percent in euro terms. This was due to the continually positive performance of the Baby Annabell branded play concept in the accessories market. At EUR 12.6 million, total sales in Northern Europe came in 6 percent below the previous year's figure, primarily because of a negative development of business in Scandinavia.

Southern Europe recorded sales of EUR 5.9 million, which is 10 percent below last year's figure. This development was mainly caused by a postponement of revenues to the third quarter of 2004.

# Report for the first half-year 2004

On the American market, the company's strategy of concentrating on its core business with play and functional dolls including accessories and of focusing on the three most important key customers has begun to show its effects. Sales development in America, which is a key growth market for Zapf Creation, is thus back on track. Sales in local currency terms were up 7 percent to USD 10.1 million. Calculated in euros, revenues equaled EUR 8.2 million, which is a decrease of 4 percent versus the previous year.

## Baby Annabell brand shows strongest growth in first six months of 2004

With growth of around 30 percent, the Baby Annabell branded play concept achieved sales of EUR 12.8 million in the first six months, thus continuing the uninterrupted success story it has enjoyed since its market launch in 1998.

The BABY born® concept went from EUR 24.8 million in sales to EUR 21.7 million at the half-year mark. The reason for this was a decrease in the sale of accessories. In order to counter this development, new thematic accessory lines will be offered throughout the coming fiscal year, which should stimulate sales.

## Breakdown of sales by product lines

	H1/2004	H1/2003	+/-
	K€	K€	in %
<b>Large dolls</b>	<b>45,539</b>	<b>50,938</b>	<b>- 11</b>
BABY born®	21,667	24,745	- 12
Baby Annabell	12,782	9,856	30
CHOU CHOU	9,245	12,462	- 26
Others	1,845	3,875	- 52
<b>Mini dolls</b>	<b>1,981</b>	<b>5,292</b>	<b>- 63</b>
<b>All others</b>	<b>2,192</b>	<b>3,784</b>	<b>- 42</b>
<b>Net sales</b>	<b>49,712</b>	<b>60,014</b>	<b>- 17</b>

Sales of the CHOU CHOU line decreased at the half-year point from EUR 12.5 million to EUR 9.2 million. This development will probably be turned around firmly in the second half of the year through the launch of the new Love me CHOU CHOU functional doll. Even before being introduced to the American market, US industry experts gave Love me CHOU CHOU the DOTY (Doll of the Year) Award. This award distinguishes, among other things, the most beautiful play dolls under USD 100 and is presented in cooperation with Doll Reader Magazine.

Sales in the mini doll segment, which consists primarily of BABY born® miniworld, declined as expected in the first half of the year from EUR 5.3 million to EUR 2.0 million. This market segment, which is actually growing, still holds sales potential for Zapf Creation. Therefore, an entirely new line of mini dolls, which will not be sold under the umbrella of the BABY born® brand, will be introduced in 2005.

## Outlook

Overall, the business development of Zapf Creation stabilized as expected in the second quarter. The market launch of the New BABY born® and Love me CHOU CHOU functional doll also promises to stimulate sales in the second half of the year. However, it cannot be assumed that it will be possible to entirely compensate for the decrease in sales in the first quarter, which resulted primarily from business in Central Europe and declining sales in the mini doll segment, over the course of the entire year. Instead, Zapf Creation is anticipating that sales in the mini doll segment will continue to decrease from EUR 14.1 million in 2003 to around EUR 7 million by the end of 2004. Zapf Creation AG continues to expect sales of about EUR 190 million and earnings before interest and taxes of around EUR 24 million for fiscal year 2004.

# The Stock

## Zapf Creation stock

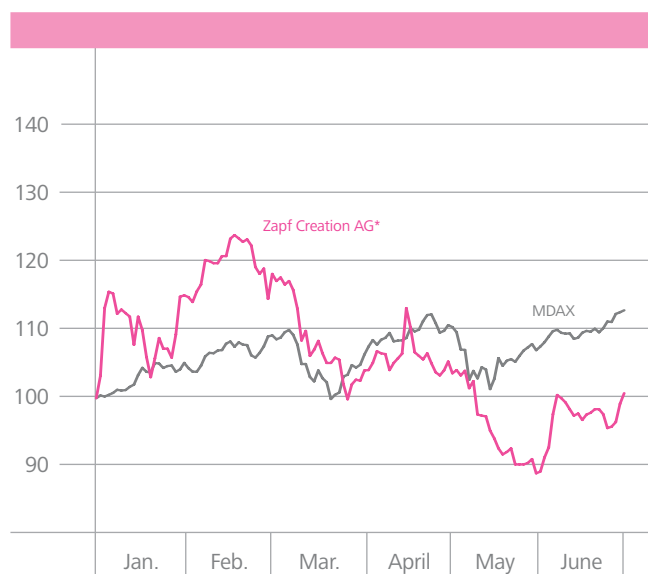
In the second quarter of 2004, Zapf Creation stock again failed to display an upward trend. On the contrary: The stock had to sustain the impact of the dividend payment in May and suffered a further drop to its low of EUR 17.10 on June 1, 2004.

Following the announcement of the sales and earnings guidance on June 7, 2004, the stock recovered slightly and reached a price of EUR 19.35 at the end of the second quarter. The publication of the outlook on fiscal year 2004 eliminated a significant uncertainty factor in connection with Zapf Creation stock among market participants. The Management Board expects sales to decrease by about EUR 10 million to EUR 190 million in 2004.

As the management has streamlined cost structures and has taken measure to reduce costs, it intends to increase the profitability of the Zapf Creation Group despite the expected decline in sales.

The capital market, however, reacted cautiously to the announcements and has obviously chosen to wait whether the company is able to solve its problems on the American continent. The limited visibility with regard to the important Christmas business also makes many investors take a wait-and-see stance. This uncertainty is reflected in the greatly varying assessments which have been published recently by analysts.

## Stock performance 2004 (Index)



ISIN: DE 000 780 6002  
 Reuters code: ZPF.ETR  
 Bloomberg code: ZPF GR  
 Number of shares: 8 million

\*Closing price Xetra, daily

## Research coverage/Analyst recommendations

Analyst	Date	Recommendation
ABN Amro	June 2004	Reduce
Bayerische Landesbank	June 2004	Neutral
Berenberg Bank	June 2004	Buy
CAI Cheuvreux	June 2004	Underperform
Deutsche Bank	June 2004	Buy
Dresdner Kleinwort Wasserstein	June 2004	Hold
DZ Bank	June 2004	Buy
Hamburger Sparkasse	June 2004	Hold
HSBC Trinkaus & Burkhardt	June 2004	Reduce
HypoVereinsbank	June 2004	Underperform
Bankhaus Lampe	April 2004	Sell
Commerzbank	April 2004	Equal weight
Cazenove	Jan. 2004	Hold

# The Stock

## Directors' dealing

During the period from April 1 to June 30, 2004, the officers and directors of the Company did not engage in any dealings as defined by § 15a of the German Securities Trading Act (WpHG).

## Treasury stock

Zapf Creation AG owns two separate securities portfolios, which are used in different ways:

Portfolio No. 1 exclusively serves to back the stock option plan.

Portfolio No. 2 includes shares which in the past were frequently offered to employees at preferred prices because of the positive development of the Company's business or in connection with successfully completed projects.

There were no changes regarding the securities portfolios as compared to December 31, 2003.

	<b>Stock Number</b>	<b>Book value K€</b>	<b>Percentage of share capital in %</b>
Portfolio No. 1	569,593	11,262	7.12
Portfolio No. 2	3,085	96	0.04
<b>Total</b>	<b>572,678</b>	<b>11,358</b>	<b>7.16</b>

## Financial calendar

<b>Date</b>	<b>Event</b>	<b>Place</b>
July 21, 2004	Results Q2/half-year 2004	
July 21, 2004, 4:00 p.m.	Global Conference Call	
August 11, 2004	Roadshow in the Netherlands	The Netherlands
October 26, 2004	Results Q3/9 months 2004	
October 26, 2004	Global Conference Call	
November 24, 2004	"Deutsches Eigenkapitalforum" of Deutsche Börse AG	Frankfurt

# Financial Statements

## Consolidated Income Statement

of Zapf Creation AG, Roedental, for the period from January 1 through June 30, 2004 (US GAAP)

	Q2/2004 K€	Q2/2003 K€	H1/2004 K€	H1/2003 K€	H1 +/- in % <sup>1)</sup>
Net sales	30,577	30,922	49,712	60,014	- 17
Cost of goods sold	- 12,799	- 12,453	- 21,456	- 25,282	- 15
<b>Gross profit</b>	<b>17,778</b>	<b>18,469</b>	<b>28,256</b>	<b>34,732</b>	<b>- 19</b>
Selling and distribution expenses	- 6,201	- 4,497	- 10,155	- 9,862	3
Marketing expenses	- 4,496	- 4,474	- 7,310	- 7,186	2
Administrative expenses, net	- 4,568	- 6,836	- 10,345	- 12,891	- 20
<b>EBIT – Operating profit before interest and taxes</b>	<b>2,513</b>	<b>2,662</b>	<b>446</b>	<b>4,793</b>	<b>- 91</b>
Interest income	80	31	129	70	84
Interest expense	- 743	- 611	- 1,485	- 1,296	15
<b>EBT – Profit before income tax expense</b>	<b>1,850</b>	<b>2,082</b>	<b>- 910</b>	<b>3,567</b>	<b>n/a</b>
Income tax expense	- 652	- 364	281	- 798	n/a
<b>Net income</b>	<b>1,198</b>	<b>1,718</b>	<b>- 629</b>	<b>2,769</b>	<b>n/a</b>
Gross margin in %	58.1	59.7	56.8	57.9	- 2

	Q2/2004 K€	Q2/2003 K€	H1/2004 K€	H1/2003 K€	H1 +/- in % <sup>1)</sup>
<b>Breakdown of personnel expenses<sup>2)</sup></b>					
Sales and distribution department	1,666	2,032	3,972	4,153	- 4
Marketing department	1,043	563	1,645	1,196	38
Administrative department	3,277	2,896	5,661	5,667	0
<b>Total</b>	<b>5,986</b>	<b>5,491</b>	<b>11,278</b>	<b>11,016</b>	<b>2</b>

<sup>1)</sup> rounded

<sup>2)</sup> already included in operating expenses

# Financial Statements

## Consolidated Balance Sheet

of Zapf Creation AG, Roedental, as of June 30, 2004 (US GAAP)

	June 30, 2004	June 30, 2003	Dec. 31, 2003
	K€	K€	K€
<b>Assets</b>			
Cash and cash equivalents	8,069	6,111	15,342
Accounts receivable	42,060	35,527	47,899
Inventories	42,866	41,390	29,118
Prepaid expenses	6,363	4,033	5,700
Other current assets	6,929	8,421	3,470
Deferred tax assets (short-term)	4,815	2,531	1,625
<b>Total current assets</b>	<b>111,102</b>	<b>98,013</b>	<b>103,154</b>
Property, plant, equipment and software, net	28,179	28,224	28,428
Intangible assets, net	2,304	2,670	2,494
Deferred tax assets (long-term)	406	230	347
Other long-term receivables	50	0	0
<b>Total long-lived assets</b>	<b>30,939</b>	<b>31,124</b>	<b>31,269</b>
	<b>142,041</b>	<b>129,137</b>	<b>134,423</b>
<b>Liabilities and stockholders' equity</b>			
Current portion of long-term debt and short-term borrowings	65,734	30,824	40,506
Accounts payable	11,087	13,247	10,088
Accrued liabilities	2,667	3,329	11,346
Income taxes payable	1,744	3,630	1,463
Deferred tax liabilities (short-term)	501	1,319	497
<b>Total current liabilities</b>	<b>81,733</b>	<b>52,349</b>	<b>63,900</b>
Long-term debt	12,480	18,598	14,780
Other long-term liabilities	47	42	67
Deferred tax liabilities (long-term)	585	973	585
<b>Total long-term liabilities</b>	<b>13,112</b>	<b>19,613</b>	<b>15,432</b>
Common stock	8,000	8,000	8,000
Additional paid-in capital	8,052	8,816	8,052
Treasury stock	- 11,358	- 1,829	- 11,358
Accumulated other comprehensive income (loss)	- 4,143	- 3,206	- 4,304
Retained earnings	46,645	45,394	54,701
<b>Total stockholders' equity</b>	<b>47,196</b>	<b>57,175</b>	<b>55,091</b>
	<b>142,041</b>	<b>129,137</b>	<b>134,423</b>



# Financial Statements

## Consolidated Statement of Cash Flows

of Zapf Creation AG, Roedental

	H1/2004 K€	H1/2003 K€
<b>Cash flow from operating activities:</b>		
Net income	- 629	2,769
Adjustments to reconcile net income to net cash flow from operating activities:		
Depreciation and amortization	3,348	3,348
Loss (gain) on sale of property, plant, equipment and software	- 36	- 22
Stock-based compensation expense	0	199
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	5,749	21,992
Inventories	- 13,749	- 11,738
Prepaid expenses and other assets	- 4,173	- 7,402
Accounts payable, accrued liabilities and other liabilities	- 7,685	- 12,646
Income taxes payable	275	- 1,203
Deferred taxes	- 3,245	- 94
<b>Net cash flow from operating activities</b>	<b>- 20,145</b>	<b>- 4,797</b>
<b>Cash flow from investing activities:</b>		
Proceeds from sale of property, plant, equipment and software	497	229
Capital expenditures	- 3,309	- 4,582
<b>Net cash flow from investing activities</b>	<b>- 2,812</b>	<b>- 4,353</b>
<b>Cash flow from financing activities:</b>		
Net borrowings under short- and long-term debt agreements	22,907	6,166
Purchases of treasury stock/proceeds from issuance of treasury stock	0	2,762
Payment of dividends	- 7,427	- 7,924
<b>Net cash flow from financing activities</b>	<b>15,480</b>	<b>1,004</b>
Effect of foreign exchange rate changes on cash	204	- 593
<b>Net increase in cash</b>	<b>- 7,273</b>	<b>- 8,739</b>
Cash at beginning of period	15,342	14,850
Cash at end of period	8,069	6,111

# Financial Statements

## Consolidated Statement of Stockholders' Equity

of Zapf Creation AG, Roedental

	Shares outstanding number (thsd.)	Common stock K€	Additional paid-in capital K€
<b>Balance at December 31, 2002:</b>	<b>7,874</b>	<b>8,000</b>	<b>8,406</b>
Net income			
Other comprehensive income (loss)			
<b>Total comprehensive income (loss)</b>			
Dividend payments			
Purchase of treasury stock			
Issuance of treasury stock	91		410
<b>Balance at June 30, 2003:</b>	<b>7,965</b>	<b>8,000</b>	<b>8,816</b>
Net income			
Other comprehensive income (loss)			
<b>Total comprehensive income (loss)</b>			
Dividend payments			
Purchase of treasury stock	- 542		
Issuance of treasury stock	4		- 764
<b>Balance at December 31, 2003:</b>	<b>7,427</b>	<b>8,000</b>	<b>8,052</b>
Net income			
Other comprehensive income (loss)			
<b>Total comprehensive income (loss)</b>			
Dividend payments			
Purchase of treasury stock			
Issuance of treasury stock			
<b>Balance at June 30, 2004:</b>	<b>7,427</b>	<b>8,000</b>	<b>8,052</b>

## Notes

The Consolidated Financial Statements of the Company and its subsidiaries were prepared in accordance with the "United States Generally Accepted Accounting Principles" (US GAAP). All amounts are stated in euros ("€").

For the period from January 1 to June 30, 2004, no changes regarding the scope of consolidation, the principles of consolidation and the currency translation have to be noted as compared to the consolidated financial statements for fiscal year 2003. The accounting principles also remained the same.

Accumulated other comprehensive income (loss)					
Treasury stock K€	Retained earnings K€	Adjustments to currency translation K€	Derivative financial instruments K€	Total equity K€	
- 4,181	50,549	- 1,987	0	60,787	
	2,769			2,769	
		- 1,219		- 1,219	
	2,769	- 1,219	0	1,550	
	- 7,924			- 7,924	
				0	
2,352				2,762	
- 1,829	45,394	- 3,206	0	57,175	
	9,307			9,307	
		- 1,112	14	- 1,098	
	9,307	- 1,112	14	8,209	
				0	
- 10,415				- 10,415	
886				122	
- 11,358	54,701	- 4,318	14	55,091	
	- 629			- 629	
		255	- 94	161	
	- 629	255	- 94	- 468	
	- 7,427			- 7,427	
				0	
				0	
- 11,358	46,645	- 4,063	- 80	47,196	

As of June 30, 2004, the company no longer discloses costs incurred in connection with the SAP software under "other administrative expenses" but assigns them to the users from the areas which cause these costs to be incurred.

The figures shown in the consolidated balance sheet, income statement, cash flow statement and development of stockholders' equity reflect the ordinary course of business at Zapf Creation AG and do not include extraordinary items. No significant events took place after the closing date.



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