Turtle Beach Corporation

2Q FY2015 Prepared Comments

August 6, 2015

Turtle Beach is providing a copy of these prepared remarks in combination with its press release to provide shareholders and analysts with additional time and detail for analyzing our results in connection with our quarterly conference call. As previously scheduled, the conference call was held on August 6, 2015 and included comments by Turtle Beach's management team followed by questions and answers. To access the broadcast, please visit the Investor Relations section of Turtle Beach's Website at http://investor.turtlebeachcorp.com/events.cfm.

Tom Naples

Thank you. Good afternoon everyone and welcome to the Turtle Beach Corporation second quarter 2015 earnings call to discuss the financial results. Before we get started, we will be referring to the press release filed today with details of the results which can be downloaded from the investor relations page of our website at corp.turtlebeach.com. In addition, a recording of the call will be available on the Investor Relations section of the Company's website later this evening.

Please be aware that some of the comments made during our call may include forward-looking statements. These statements involve risks and uncertainties regarding our operations and future results that could cause Turtle Beach Corporation's results to differ materially from management's current expectations. We encourage you to review the Safe Harbor statements and Risk Factors contained in today's press release and in our filings with the Securities and Exchange Commission, including, without limitation, our most recent Form 10-K and our other periodic reports which identify specific risk factors that may cause actual results or events to differ materially from those described in forward-looking statements.

We also note that on this call we will be discussing non-GAAP financial information. We are providing that information as a supplement to information prepared in accordance with accounting principles generally accepted in the United States, or GAAP. You can find a reconciliation of these metrics to our reported GAAP results in the reconciliation table provided in today's earnings release.

And now, I'll turn the call over to Juergen Stark, the Company's Chief Executive Officer.

Juergen Stark

Good afternoon and welcome everyone on the call with us today. John Hanson, our Chief Financial Officer, is here to cover our financial performance and outlook after I share some highlights on the business. I will then give some concluding thoughts before we open up the call to your questions.

Our second quarter sales results were within our guidance range and when you exclude one-time charges, our adjusted EBITDA and net income exceeded our guided expectations. On top of our financial performance we made important progress on four major areas that we believe are critical to driving sustained growth and improved profitability. They are;

- Growing sales and gross profit of our leading portfolio of next generation gaming headsets;
- Preparing for the successful launch of HyperSound Clear;
- Transitioning to our soon-to-be announced new manufacturing partner;
- And improving our capital structure.

Beginning with our next generation of gaming headsets, sales and margins were strong. During the second quarter domestic sales of our Xbox One and PlayStation4 compatible headsets several of which feature industry first and only innovations increased over 70% versus Q2 last year. Our next generation headsets also delivered margins roughly 10 percentage points above our previous generation headsets and are expected to be well over 30% gross margin for the year. We believe this is a great indicator of what’s to come as the new console generation user base surpasses the previous generation which is expected to happen later this year.

An even better measure of our brand and product strength is sell-through which provides more accurate read on consumer demand. According to the latest NPD US Retail sales data, 4 of the top 5 third party Xbox One headsets and 3 of the top 5 third party PS4 headsets year-to-date are Turtle Beach. Of note, our XO1 headset is the top selling Xbox One third party headset and our Stealth 400 is the top selling third party PS4 headset as measured by dollars. In addition, our Stealth 500X is the largest selling Xbox One gaming headset above $200 which along with the Elite 800X, the most technologically advanced gaming headset ever, has helped us increase our share of the premium end of the market to almost 40% from under 10% a year ago. At the same time our Stealth 420X, which just launched in July, is the #1 new release on Amazon in Xbox One Headsets and has garnered an incredible 4.7 rating – currently the highest of any gaming headset on Amazon. Later this year, we are introducing several new high-quality gaming headsets with innovative features like the PX24’s SuperAmp that delivers powerful sound from any connected device and adds features like surround sound and our amazing Superhuman Hearing capability.

We believe that the work we’ve done over the past 20 months to bring to market the broadest, best, cutting edge portfolio of next generation headsets has helped strengthen the connection between us and our consumer audience and further solidify our dominant position at retail in console gaming headsets. In fact, we estimate that we have now sold over $1 billion in gaming headsets in the past 8 years.

As we said on our previous earnings calls, the transition from previous gen to next gen will and has put pressure our operating results and the decline in old gen consoles and accessories continues to be faster than we or analysts expected. When looking at our business, we think it's important to understand the performance of the declining old gen headsets separately from the rapidly growing next gen headsets. Particularly given the fact that we are one of the largest providers of hardware accessories for consoles and had a far larger business in XB360 and PS3 headsets than any other company. As the old gen segment has declined faster than expected, we've had to respond with promotions and credits to help our retail partners move their inventory. That impacted gross margins by almost 600 basis points in Q2. Promotional activity so far this year has been 2 to 3 times higher on old gen than next gen. In fact, we estimate that next gen headsets are producing about 10% higher gross margins than old gen headsets reflecting success of new product launches and normal higher margins for products earlier in their lifecycle. Recall that even a few million dollars of credits or above gross margin costs have a very large impact on the gross margin percentage given our normal, lower revenue base in the early quarters of the year. Two million dollars drive roughly 8% gross margin change in Q2 vs. roughly 2% in Q4. Our bias has been and continues to be to take the actions that we need to take to prudently manage the declining old gen business. The good news is that old gen continues to become a smaller part of our business, in fact just under 25% of our revenues for the year so far. In contrast to 100% of our business 2 years ago. Obviously old gen will continue to decline as a share of our business as that console generation winds down.

Overseas, our next-gen products are also performing well in our established markets led by the U.K. where we continue to own a dominant market share position. However, like the U.S., we are experiencing sales and margin pressure from the decline in old-gen demand in addition to more challenging overall market conditions due to the strong dollar. Despite these near-term headwinds, we remain confident that our international markets provide compelling long-term growth opportunities for our gaming headset business.

Looking ahead, we are confident that our audio engineering and product development expertise, leading placement at retail, and strong brand affinity among the gaming community have us well positioned to capitalize on the positive trends expected to benefit the industry in the coming years.

The quarter was also highlighted by excellent progress toward the launch of HyperSound Clear™, our groundbreaking in-home solution for helping people with hearing loss to better understand and enjoy TV, music and other media. Importantly, we secured partnerships with industry leading channel partners that collectively represent about 4,000 hearing healthcare offices and retail locations in the U.S. Or roughly 30% of the total US points of distribution. They include American Hearing Aid Associates, Amplified Resource Group, AudConnex, Fuel Medical Group and Audiology Management Group. An incredibly powerful distribution network already to go to launch HyperSound with more channel deals are in process.

In preparation for a fourth quarter launch, the HyperSound business led by Rodney Schutt and his team of hearing health veterans, has been performing patient trials in doctor's offices across the country. The results continue to support our confidence in the growth prospects for this one-of-a-kind product that we believe is going to reshape the audio experiences for the hard of hearing.

Meanwhile, the supply chain, including the first ever mass production of this type of ultrasound emitter, is coming along. As I've discussed, there are multiple unique and new elements to the production of the HyperSound hearing product which we are working through. Also, as I previously stated we will only launch when we are certain we can support mass production with high quality and high consumer satisfaction. And we have continued to drive longer term research and innovation around our HyperSound technology including good progress using materials which enable a transparent emitter.

Our supply chain transformation, led by Rod Andris, continues with excellent progress. We've now successfully wound down one of our 3 China-based manufacturers and began production of several models of gaming headsets with a new global manufacturing partner. This new global platform provides us with several benefits including cost savings as well as ability to pursue regional manufacturing of headsets over time. In addition, our soon-to-be-announced new partner is also handling the manufacturing of HyperSound Clear which creates some nice synergies with our headset business.

Finally, and perhaps most importantly, we recently improved our capital structure by putting in place long-term debt that places the company in a much better position to capitalize on the many opportunities that we believe exist for the Turtle Beach and HyperSound brands. To recap, in July;

- We signed a $15 term loan with Crystal Financial LLC, a great new partner that was introduced to us by our global lender, Bank of America Merrill Lynch;
- And we amended roughly $14 million of existing subordinated debt held by affiliates of Stripes Group LLC, our largest shareholder.

The roughly $29 million in aggregate total term debt matures in 2019 and bears interest at LIBOR plus 10.25%. We eliminated the multiple short-term maturities in our subordinated notes. In exchange for extending the maturity and lowering the long-term interest rate on the subordinated debt, we issued the subordinated noteholders warrants to purchase approximately 1.7 million shares of common stock with an exercise price set at $2.54, a 20% premium to the closing price on July 21, 2015.

We believe the combination of our $60 million global credit facility with Bank of America, the new long-term debt, and cash flow generated by our gaming headset business will allow us fund the near-term expenses associated with the upcoming launch of HyperSound Clear along with the one-time cash needs associated with the supply chain manufacturing transition. Longer-term, our improved capital structure provides us greater liquidity to fund our annual working capital needs, particularly during the first half of the year when the gaming industry is seasonally slow. We are pleased with the outcome of this recent process and very pleased to be working with both BofA and Crystal Financial.

And with that, I'll turn it over to John

John Hanson

Thanks, Juergen.

In my presentation I will be discussing the consolidated results on a year over year basis.

Beginning with the top-line, net revenue in the second quarter of 2015 totaled $22.6 million compared to $22.3 million a year ago. The 1.4% increase was attributable to a 9.6% gain in domestic sales driven primarily by strong consumer response to our expanded portfolio of next generation headsets. This was partially offset by an overall decline in previous generation headset products and softer international sales due to a highly promotional environment and changes in foreign exchange rates.

Gross profit for the second quarter was $3.4 million, compared to $4.8 million in the same period in 2014. Gross margin was 15.0% in the second quarter, including the impact of promotional credits to continue to clear previous generation and licensed headset inventory and some modest incremental contract manufacturer transition costs, which reduced margins by approximately 700 basis points. For the full year we still expect margins to improve to the low 30% range due to lower costs realized from the contract manufacturer change, logistics cost improvement projects and manufacturing fixed cost leverage as we head into our higher revenue quarters.

Operating expenses in Q2 were $16.0 million, compared with $14.0 million during the same period in 2014. The increase in operating expenses was primarily attributable to higher costs associated with additional headcount, significantly higher legal fees, incremental stock compensation expense and investments in personnel and product development of our HyperSound® technology. This was partially offset by lower selling and marketing expenses due to lower trade show spend in connection with a strategic shift to more targeted promotional activity and savings related to the termination of certain licensing agreements.

We reported a net loss for the second quarter of ($9.9) million, or ($0.23) per diluted share based on 42.2 million average shares outstanding, compared to a net loss of ($9.3) million or ($0.23) per diluted share based on 40.8 million average shares outstanding in the same period a year ago. This was slightly below guidance of a net loss between ($9.5) million to ($7.5) million, due to the aforementioned significant incremental promotional activity to continue to clear old gen and licensed product inventory and modest incremental contract manufacture transition costs.

Q2 2015 adjusted EBITDA for the headset business was approximately ($5.2) million in the second quarter compared to ($4.7) million in the second quarter of 2014. Adjusted EBITDA on a consolidated basis was ($8.2) million, reflecting investments of approximately $3.0 million in the HyperSound business during the quarter, which was within guidance of a net loss between ($9.0) million to ($7.0) million.

Please note that we provided a reconciliation of GAAP reported results to adjusted EBITDA in the accompanying tables at the end of the press release we issued today.

Now, turning to the balance sheet.

Starting with our cash position, at the end of the second quarter we had cash and cash equivalents of $3.0 million, compared to $7.9 million at December 31, 2014. The decrease in cash from year-end is due to our HyperSound investments and higher purchases to support the contract manufacturer transition. Total inventory as of June 30, 2015 was $37.3 million a 2.8% decrease from $38.4 million on December 31 2014. The company is carrying a higher level of inventory today to support the contract manufacturer change.

I want to walk through the specifics of our current capital structure and the steps we've taken to fund our growth for the next several years.

Outstanding debt at June 30, 2015 decreased 24.1%, or $10.7 million, to $33.8 million compared to $44.6 million at December 31, 2014. The debt consisted of $14.8 million of borrowings under the Company's Revolving Credit Facility, a $7.1 million term loan and $11.9 million of subordinated debt.

Following the end of the quarter, we announced a new $15 million term loan with Crystal Financial, LCC, and amendments to our outstanding subordinated debt held by affiliates of Stripes Group LLC, of which $13.9 million of subordinated debt remains outstanding with maturities extended to 2019 at an interest rate of LIBOR plus 10.25% which is aligned with the new term loan. As consideration for the amended terms, we approved a grant to those affiliates of Stripes for warrants to purchase approximately 1.7 million shares of common stock with an exercise price set at $2.54, a 20% premium to the closing price on July 21, 2015. The warrants represent 4% of the currently outstanding shares and increase the number of fully diluted shares from approximately 48.7 million to approximately 50.4 million. In connection with the term loan, we also amended our revolving credit facility with Bank of America Merrill Lynch. Both loans, are in addition to the Company's existing $60 million global credit facility with Bank of America Merrill Lynch.

The combination of our global credit facility, long-term debt, and cash flow generated by our gaming headset business will allow us to cover start-up expenses related to the upcoming launch of *HyperSound Clear*™ and one-time cash needs associated with the transition to our new manufacturing partner.

Now turning to our outlook.

Starting with the full year, we still expect 2015 headset revenue to be approximately flat compared to 2014. Adjusted headset EBITDA margins are still expected to be in the 8% to 9% range compared to 6.5% in 2014 with gross margins improving into the low 30 percent range.

As a reminder, our projections are highly dependent on the projected rate of growth of our next generation headsets versus the decline of our previous generation headsets and the potential negative impact from changes in foreign currency exchange rates both of which have pressured first half results more than expected. The stronger US dollar has a translational impact on our results as well as effects sales volumes and margin for our international distributors. If exchange rates stay where they are, we could realize a $3 million to $5 million hit to revenue and a $1 million to $2 million hit to adjusted EBITDA over the course of the year.

With regard to HyperSound, as Juergen mentioned, we remain on schedule for the fourth quarter launch of our HyperSound hearing product and therefore we are still forecasting a few million dollars in HyperSound revenue late this year. Our gross margin target for HyperSound remains 50% or better long term but obviously may be lower in the near term given fixed operating costs until revenues ramp. On an adjusted EBITDA level, we are targeting our net investment in HyperSound not to exceed $9 million in 2015 with a dependency on exact launch timing.

For the third quarter 2015, we currently expect net revenue for our headset business to be in the range of $30 million to $35 million, roughly flat with the same period a year ago at the mid-point of the range.

Net loss for the third quarter is projected to be between ($4.5) million and ($7.5) million and adjusted EBITDA is expected to be between a loss of ($1.0) million to ($5.0) million which includes approximately $4.0 million in planned HyperSound investment. Adjusted EBITDA for the Headset business is projected to be between break-even and $3.0.

Now, I'll turn the call back over to Juergen for some closing comments.

Juergen Stark

Thanks John.

Before we turn it over for questions, I'd like to sincerely thank the entire Turtle Beach team for their continued excellent work launching great headsets, diligently managing the console transition and all the associated dynamics, preparing our ground-breaking HyperSound Clear product for launch, and driving the broad set of operational improvements we have underway.

I also want to thank our shareholders for their trust and support and look forward to seeing investors at our upcoming presentations at the B.Riley and Liolios conferences in September.

Looking ahead, I believe we are well positioned strategically, operationally and financially to capitalize on the growth opportunities we've created through our product innovations and strong retail partnerships. The performance of our next generation gaming headsets is providing us strong momentum as we head toward the cross over point when the next-gen console user base surpasses the old-gen and into the holiday season and we are confident that HyperSound Clear will resonate with a broad commercial audience when it is launched later this year.

Operator, we are now ready to take questions.

Forward-Looking Statements

These remarks include forward-looking information and statements within the meaning of the federal securities laws. Except for historical information contained in this release, statements in this release may constitute forward-looking statements regarding assumptions, projections, expectations, targets, intentions or beliefs about future events. Forward looking statements are based on management's statements containing the words "may", "could", "would", "should", "believe", "expect", "anticipate", "plan", "estimate", "target", "project", "intend" and similar expressions constitute forward-looking statements. Forward-looking statements involve known and unknown risks and uncertainties, which could cause actual results to differ materially from those contained in any forward-looking statement. Forward-looking statements are based on management's current belief, as well as assumptions made by, and information currently available to, management.

While the Company believes that its expectations are based upon reasonable assumptions, there can be no assurances that its goals and strategy will be realized. Numerous factors, including risks and uncertainties, may affect actual results and may cause results to differ materially from those expressed in forward-looking statements made by the Company or on its behalf. Some of these factors include, but are not limited to, the substantial uncertainties inherent in acceptance of existing and future products, the difficulty of commercializing and protecting new technology, the impact of competitive products and pricing, general business and economic conditions, risks associated with the expansion of our business including the implementation of any businesses we acquire, our indebtedness, and other factors discussed in our public filings, including the risk factors in Turtle Beach's most recent Annual Report on Form 10-K, Quarterly Report on Form 10-Q and other periodic reports filed with the SEC and available on the SEC's website, www.sec.gov. Except as required by applicable law, including the securities laws of the United States and the rules and regulations of the Securities and Exchange Commission, the Company any is under no obligation to publicly update or revise any forward-looking statement after the date of this release whether as a result of new information, future developments or otherwise.

Key Performance Indicators and Non-GAAP Measures

Management routinely reviews key performance indicators including revenue, operating income and margins, earnings per share, among others. In addition, we consider other certain measures to be useful to management and investors evaluating our operating performance for the periods presented, and believe these additional measures provide a tool for evaluating our ongoing operations, liquidity and management of assets. These metrics, however, are not measures of financial performance under accounting principles generally accepted in the United States of America ("GAAP") and should not be considered a substitute for net income (loss) or other consolidated income statement data as determined in accordance with GAAP. These other measures may not be comparable to similarly titled measures employed by other companies. We consider the following non-GAAP measure, which may not be comparable to similarly titled measures reported by other companies, to be key performance indicators:

Adjusted EBITDA

"Adjusted EBITDA" is defined as net income (loss) before interest, taxes, depreciation and amortization, stock-based compensation (non-cash), non-cash amortization of payments to founders and certain business transaction expenses. Management adjusts net income (loss) for business transaction costs because it believes that such items are not representative of core operations. We believe Adjusted EBITDA provides useful information to investors about us and our financial condition and results of operations for the following reasons: (i) it is one of the measures used by our board of directors and management team to evaluate our operating performance; (ii) it is one of the measures used by our management team to make day-to-day operating decisions; (iii) the adjustments made in our calculation of Adjusted EBITDA (business transaction costs, payments to our founders, and stock-based compensation) are often viewed as either non-recurring or not reflective of ongoing financial performance or have no cash impact on operations; and (iv) it is used by securities analysts, investors and other interested parties as a common operating performance measure to compare results across companies in our industry by backing out potential differences caused by variations in capital structures (affecting relative interest expense), and the age and book value of facilities and equipment (affecting relative depreciation expense).

Adjusted EBITDA has limitations as an analytical tool, and when assessing our operating performance, it should not consider Adjusted EBITDA in isolation or as a substitute for net income (loss) or other consolidated income statement data. Some of these limitations include, but are not limited to:

- Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

- Adjusted EBITDA does not reflect interest expense, or the cash requirements necessary to service interest or principal payments, on our debt;

- Adjusted EBITDA does not reflect income taxes or the cash requirements for any tax payments; and

- Other companies may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.