

Mattel, Inc.
CLIENT REPORT
SONTAG SOLUTIONS



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Professor Likens' Senior Seminar

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Executive Summary

Mattel has experienced five straight quarters of declining sales and missed earnings expectations, which have cut the stock value of the company nearly in half since 2013. The toy industry as a whole, however, has actually grown over the past year, with industry rivals gaining market share at Mattel's expense. The once-largest toy maker in the world has been dethroned by the Lego Group riding the success of *The Lego Movie*, while archrival Hasbro has secured Disney Princesses, Mattel's most valuable license, starting in 2016.

Declining sales aside, Mattel has strong core financials, with acceptable levels of debt and the cash reserves to weather the downturn while still paying out a generous dividend to prop up stock prices. The company has an internationally diversified manufacturing base with best-in-industry quality control practices. Mattel also has some of the most powerful and recognizable toy brands in the world, built up over a half century. Despite these advantages, the company is falling behind and needs a new strategy for the future.

Mattel needs to stop thinking of itself as just a toy company and embrace being a total brand experience. By leveraging the global power of Mattel's core brands across multiple industries such as movies, clothing, and games the company can not only revitalize sales but create new revenue streams through licensing. Barbie has made \$100 million in 31 small-scale direct-to-video releases over 15 years. Hasbro has made \$3.7 billion in box office receipts alone from the Transformers franchise, as well sales from entire new movie related toy and video game lines. Mattel should also embrace diversity in its product lines to not only boost domestic sales but to better tap into international markets. Developing markets will also give Mattel's more traditional toys a respite from having to compete as fiercely with modern electronics.

Company Background

In 1945, Harold "Matt" Matson and Elliot Handler founded Mattel Creations in El Segundo, California, although Matson sold his stake to Handler soon after founding. The company started out making picture frames, with a side business in making dollhouse furniture from the scraps. Eventually Mattel turned its wood working equipment to making a child-sized ukulele, and the company had its first hit product. Mattel began manufacturing other kinds of toys, and by 1955 it was worth a half million dollars and had attracted the attention of the Walt Disney Company. Disney offered Mattel a gamble: they could sponsor a segment of the newly developed Mickey Mouse Club for a year, but it would cost nearly the entire net worth of the company. The Handlers took the bet, revolutionizing advertising in the toy industry and nearly tripling Mattel's sales in just three years. The Handlers compounded their success by introducing the Barbie doll, named after their daughter Barbara, in 1959.

Mattel continued to grow rapidly while continually revolutionizing the industry. The company introduced Chatty Cathy in 1960, bringing with it draw-string-activated voice boxes for the first time. Hot Wheels, a line of die-cast cars and accessories targeted at boys, was introduced in 1968 and became another top seller for the company. At this time, Mattel embarked on a series of non-toy acquisitions as part of a diversification strategy aimed at increasing their influence with children, among them pet-product companies, theme parks and Ringling Brothers and Barnum & Bailey Circus. In 1977, Mattel entered the electronics game industry as part of its diversification strategy, introducing the Intellivision, a direct competitor to the Atari 2600. Unfortunately for Mattel, the American video games industry collapsed a few years later, and many of their non-

toy ventures were taking substantial losses. By 1984, Mattel had either sold off or closed all non-toy-related subsidiaries to refocus on their core business.

After their disastrous diversification attempts, Mattel launched an internal campaign to maximize their core brands while also looking for new brands with core potential. A major part of this campaign was to renew the company's association with Disney, forming an alliance that gave Mattel the licenses for not only Disney's classic characters, but their contemporary hits as well. Mattel saw another surge of growth based on the immense popularity of toy lines for movies like Toy Story. Another major component of the campaign was another round of acquisitions, this time focusing on other toy companies with solid core products. Mattel acquired Fisher-Price, Power Wheels, Cabbage Patch Kids and others, and they merged with Tyco Toys. The 1990s were a period of rapid growth for the company.

While Mattel continued to amass companies and product licenses, including the lucrative Harry Potter license agreement and a multi-year licensing deal with children's programming network Nickelodeon, the 2000s also brought serious challenges for Mattel. In 2000, the company sold off The Learning Corporation, a software company Mattel had bought for \$3.5 billion in stock in 1999, in a zero-cash-upfront deal with an investment firm in order to get the failing software division off its books. The Learning Company, which had been rebranded as Mattel Interactive, was losing an estimated \$1 million per day, and its acquisition by Mattel has been regarded as one of the worst purchases in American corporate history¹. Mattel took a \$430 million after-tax loss on The Learning Company, and they saw an estimated \$7 billion drop in market valuation attributable to the failed software division. The next year Mattel entered into licensing agreements with game publishers Vivendi Universal and the now-defunct THQ to develop

¹ [The Telegraph: Mattel Sale Ends Fiasco](#)

interactive properties based on Mattel's products, rather than making another attempt to acquire a software division.

Mattel faced another formidable challenge from rival MGA Entertainment, which launched the Bratz line of dolls in 2001. By 2005, Bratz had nearly overtaken Barbie in sales, leading to a 30% decline in sales of Mattel's flagship doll worldwide, as Bratz climbed to a 40% market share. Mattel filed a lawsuit against MGA in 2004, alleging that a Mattel employee had come up with the concept of the Bratz doll before being hired away by MGA. Although the courts eventually ruled in favor of MGA after nearly a decade of litigation, the court costs weakened MGA's ability to continue the meteoric growth of the Bratz line, and today the doll line is a shadow of itself. MGA counter-filed against Mattel alleging corporate espionage, and, although the suit was denied by the US Court of Appeals, MGA has recently re-filed the suit, claiming the initial suit only lost on a technicality. While MGA seeks a billion dollars in damages from Mattel, it is unlikely the suit will succeed on its second try. The ongoing battle between the two companies is notable as one of the most heavily contested trade secret cases in American legal history.

In 2007, Mattel faced a serious crisis regarding its manufacturing processes. The small magnets in many of Mattel's toys were found to cause potentially fatal internal injuries if accidentally swallowed, as they could clamp intestines together. Shortly afterwards, a separate report found that Mattel's Chinese manufacturing plants were using paint with high lead concentrations. Mattel's response to the crisis, including multiple recalls totaling over 18 million products, a website coordinating product safety information, and public apologies by then-CEO Robert

Eckert both on television and the corporate website² were lauded as the new industry standard. The paint problems were tracked to a lack of quality control and oversight of manufacturing contractors and, in response, Mattel developed a rigorous safety inspection system including external auditors and inspectors for all foreign plants. Mattel received positive coverage for its handling of the crisis, and, in 2007, were still named as one of Top 100 Best Corporate Citizens. As of 2014, they are still ranked as one of the most ethical companies in the US³.

Despite challenges and setbacks, Mattel continued to be a powerhouse toy manufacturer into the 2010s, with new lines such as Monster High and new licenses from HiT entertainment (makers of Thomas the Tank Engine and Friends). Mattel would eventually acquire HiT outright. Mattel also announced the creation of Playground Productions, an internal division that would work on using the company's product lines to create new movies and series. Mattel had already enjoyed moderate success from their direct-to-DVD Barbie movies, which had earned more than \$100 million since 2001. That number pales in comparison to the \$470 million in box-office sales from The Lego Movie in 2014, or the \$3.7 billion generated by Hasbro's Transformers movies. After consolidating the HiT acquisition, Mattel next bought MEGA Brands Inc. for \$460 million in 2014 in an attempt to break into the lucrative construction toy market, where Lego reigns with a 90% market share.

Since 2013, though, Mattel has experienced a reversal of fortune. A disappointing 4th quarter, the most important quarter for Mattel's highly seasonal sales, caused the company to miss earnings targets in 2013 and began a slump that would eventually see the firing of CEO Bryan Stockton on January 26th, 2015, after five straight quarters of declining sales. The company also

² [WSJ: Mattel Does Damage Control after Toy Recall](#)

³ [Mattel Website: Top 5 Corporate Citizens](#)

slipped from the largest toy maker in the world to the second largest, losing its crown to Lego⁴. Now Mattel is struggling to rejuvenate its core brands and rebuild its market share in a fiercely competitive market.

SWOT Analysis

<i>Strengths</i>	<i>Weaknesses</i>
<ul style="list-style-type: none"> • Global brand recognition • Strong, internationally diversified manufacturing capacity and quality control • Good recent track record with acquisitions • Strong financials despite recent losses 	<ul style="list-style-type: none"> • Poor integration of toys and media • Lack of diversity in products • Over-reliance on girls' toys⁵ • Recent upheaval in leadership
<i>Opportunities</i>	<i>Threats</i>
<ul style="list-style-type: none"> • Leverage brands with comprehensive campaigns including TV, movies, clothing and games • Seek new licenses • Innovate using new technologies • Embrace diversity in doll designs 	<ul style="list-style-type: none"> • Changing consumer tastes <ul style="list-style-type: none"> ○ Rival toys ○ Consumer electronics • Intense industry competition • Seasonality of sales

Strengths

Mattel's core strength is their stable of popular brands. The company has Barbie, Hot Wheels, American Girl and Monster High, among others, as well as extensive licensing agreements for popular brands. They also have a strong manufacturing capacity, and they have excellent contractor oversight and quality control programs resulting from the 2007 recalls. In addition, Mattel is staying ahead of rising Chinese labor costs by diversifying manufacturing into India

⁴ [Time Magazine: Lego Largest Toy Company](#)

⁵ [Washington Post: Barbie is Declining, and That's Just One of Mattel's Problems](#)

and Brazil⁶. Labor costs are lower in India than in China, and while labor costs are roughly on par in Brazil Mattel can realize savings in shipping to the US, as well as greater access to the growing Latin America market.

Recent acquisitions have also been a positive for Mattel, with MEGA Brands giving the company an inroad into construction toys without having to build a brand from scratch, and HiT Entertainment being one of the few bright spots in Fisher-Prices's generally declining sales.

Mattel is also making investments into product diversification by launching new toy lines such as BOOMco, a competitor to Hasbro's NERF toy weapon brand.

Mattel also has strong financials despite its misfortunes, and it keeps enough cash on hand to take advantage of any opportunities.

Weaknesses

Mattel still believes itself to be a toy manufacturer instead of an entertainment producer. This is apparent in how the company treats its own media properties. Movie and game tie-ins have always been a secondary concern for Mattel, limiting the reach and 'lifestyle' opportunities for Mattel's brands. For instance, Mattel has released 31 direct to video Barbie movies since 2001, earning approximately \$100 million total. Lego released one major motion picture in 2014 and earned \$460 million on a production budget of \$60 million. Box office sales alone for Hasbro's Transformers franchise exceed \$3.7 billion, with a fifth movie planned for 2017. Lego and Hasbro also enjoyed considerable increases in sales from toys associated with the movies.

⁶ [Mattel Board Report Dec. 2014](#)

Mattel has also frequently given poor toy support to media properties. During the 2002 re-launch of Mattel cartoon property He-Man, the company failed to provide a range of toys to keep interest in the show alive. The company also refused to provide toy support for license partner DC Comic's Green Lantern cartoon after the failure of the live action Green Lantern movie, resulting in the cancellation of the cartoon due to lack of merchandising⁷. Mattel's repeated failures to capitalize on media merchandising may have been a contributing factor to Mattel losing the lucrative Disney Princess license to archrival Hasbro. Mattel has also had issues with diversity in its product lines. Until very recently, Barbie had very little variety in body shapes or facial features, meaning many 'diverse' Barbie dolls were simply differently colored Caucasian Barbie dolls. Barbie has also only recently gained the option to wear flats instead of high heels for the first time⁸. The lack of real diversity was one of the key weaknesses MGA exploited with the Bratz line that nearly overtook Barbie, and it contributes to lower international sales and a negative popular image for the doll. As a company, Mattel is also heavily focused on traditionally girls' toys. Barbie, American Girl and 'other girls' brands make up roughly two thirds of Mattel's sales not including Fisher-Price. The remaining one-third comes from Hot Wheels, the newly acquired MEGA Bloks and 'entertainment brands', a catch all for licensed toys.

Finally, Mattel has been experiencing an upheaval in corporate leadership due to the firing of previous CEO Bryan Stockton.

⁷ [i09: Seven Cartoons Screwed over by their Own Toy Lines](#)

⁸ [USA: Barbie Wearing Flats](#)

Opportunities

Mattel's primary opportunity would be to work more closely with license holders and studios to maximize the value of Mattel properties by creating tie-in opportunities and 'lifestyle' lines, akin to Hasbro. While Mattel is trying to develop an internal entertainment studio with Playground Productions, the company will need to partner with established media companies. Despite recent downward trends, Mattel's brands are still extremely powerful, and they have global recognition. With development and the right expertise, the company could easily bounce back from its recent losses. A coordinated campaign with movies, TV shows, video games, clothing lines and new toy tie-ins could re-invigorate any of Mattel's major brands and put the company back on top. Mattel should also continue to seek new licenses to pair with its agile manufacturing and distribution networks, and it could capitalize on its global brand recognition to increase the share of international markets as a percentage of its sales.

New technologies should also be considered to pair up with existing brands, such as Mattel's recently announced speech-recognition Barbie⁹. Enhancing diversity and representation in Mattel's core doll lines would also improve the company's image and sales.

Finally, with Mattel's cash on-hand, the company should be on the lookout for any strong acquisition candidates, although Mattel should focus on its core business first and exercise considerable caution to avoid another The Learning Company fiasco.

⁹ [Newsweek: Meet Hello Barbie](#)

Threats

Mattel faces two primary threats as a toy manufacturer. The first is changing consumer tastes. Barbie is 55 years old and needs constant updating to match modern consumer expectations, a process Mattel has frequently failed to carry out. Without the efforts of constant marketing and design Mattel will find its toys no longer in demand and falling behind the competition. No amount of updating, though, will protect Mattel from changes in consumer tastes from physical toys to video games and electronics. Mattel calls this phenomenon "children getting older younger," and it attributes part of its decline in sales to children outgrowing Mattel's toys at younger ages. Hasbro and Lego have responded by licensing video games of their own, but Mattel struggles to find large-scale audiences with its licensed Barbie games. Historically, all of the company's attempts to branch into software and electronics divisions of its own have ended in disaster.

The second major threat to Mattel comes from the intense competition in the toy industry. Archrival Hasbro has handled the transition from toy manufacturer to entertainment empire significantly better than Mattel, and it now represents a better value prospect to many of the license holders that are essential to Mattel's survival. As an example, Mattel recently lost the extremely valuable Disney Princess license - which rivals Barbie herself in popularity - to Hasbro. Mattel competes with Hasbro across most of the toy industry, from toy weapons (Hasbro's NERF to Mattel's BOOMco) to action figures (Hasbro's Marvel to Mattel's DC license). Mattel has also entered into competition with toy giant Lego with the acquisition of MEGA Brands.

Aside from the major players, Mattel competes against store brands, which may have preferential displays or prices, and specialty retailers who can be more agile in taking advantage of trends, or just plain lucky. The barriers to entry in the toy industry are relatively low and, while economies of scale exist, small batch manufacturing isn't prohibitively expensive.

Mattel is also vulnerable to the extremely seasonal nature of its industry. The fourth quarter makes or breaks the company each year, and this seasonality can make predicting inventories and year-round advertising budgets extremely difficult.

Competitive Forces Analysis (Porter's Five Forces)

Internal Rivalry

Mattel faces stiff competition within the toy industry, mainly from archrival Hasbro.

Traditionally, the market was informally split between 'girls' toys,' where Mattel dominated with Barbie and American Girl, and 'boys' toys,' where Hasbro dominated with its various wholly owned IPs like Teenage Mutant Ninja Turtles and NERF guns. Walt Disney Co., a dominant owner of character franchises, informally contributed to this division, as they typically split franchise contracts informally along these same lines. As growth in the toy industry became squeezed by electronic games, both companies sought to branch out, and they now compete in all areas. Recently, Hasbro has pulled a coup by securing the future license to the Disney Princess line, an immensely valuable IP long-held by Mattel. The Disney Princess line is the only 'girls' toy' line that has surpassed Barbie in sales in decades. Hasbro is much less vulnerable to similar

moves from Mattel, however, as many of Hasbro's most valuable lines are wholly owned instead of licensed.

Recently, Mattel acquired MEGA Brands in order to move into the construction-toy market, bringing them into rivalry with Lego, the largest toy manufacturer in the industry. While the acquisition of MEGA Brands gives Mattel a respectable 10% market share, Lego has virtually all of the other 90%, with brands like Hasbro's newly launched Kreos line accounting for less than 1% of the market. MEGA Brands does have some relative advantage within the construction-toy market with products geared specifically to the under-three market. This positioning provides some complementary product experience to the popular Fisher-Price products offered by Mattel. MEGA Brands has also had success integrating Nickelodeon (SpongeBob) and NBC Universal (Despicable Me) franchises into their construction-toy offerings. Mattel now benefits from those franchises.

Small manufacturers pose little threat to Mattel, as the company mainly deals in licensed IPs, and it relies on branding. Branding is a powerful force in the toy industry; a plastic doll similar in all other regards but lacking the Barbie or Princess Elsa name will simply not sell as well. Mattel has shown previous skill in adapting and absorbing small-scale rival manufacturers (e.g. Bratz.)

Mattel faces heavy industry competition in every product line with the possible exception of its preschool products. This competition is only expected to grow in the next 2-3 years.

Bargaining Power of Suppliers

From a manufacturing standpoint, Mattel faces relatively little threat from suppliers. Mattel owns a relatively high proportion of its production facilities compared to the industry standard, and it maintains plants in many different countries to guard against political and currency instability.

Mattel maintains strict control over its third-party manufacturers and suppliers, and it maintains what is widely considered to be one of the best inspection and accountability programs in the industry, the 2007 recalls notwithstanding. No single third-party manufacturer or supplier has sufficient bargaining power to substantially affect Mattel. The company is relatively secure from negative exposure or scandals in their manufacturing and supply chains, both as a result of lessons learned from the 2007 toy recall and a stable of positive corporate responsibility awards that can be used as a counterweight to poor press in any given region.

More goes into making a toy than just raw materials and manufacturing, however. As Disney's recent move to hand the Disney Princess license over from Mattel to Hasbro shows, Mattel is vulnerable to the suppliers of its licenses. Mattel relies heavily upon Disney, Nickelodeon and other third party licenses for a significant portion of its revenues. Loss of those licenses would have significant impact on Mattel's business, giving the license holders significant bargaining power. This dynamic is the primary market force underlying the rapid reversal of Hasbro's and Mattel's relative positions in 2013-2014.

Bargaining Power of Buyers

Mattel manufactures consumer goods, and it is highly vulnerable to changing consumer tastes. This is especially true in the toy industry, where seasonal fads may see enormous shifts in demand between toys. In addition to dealing with shifting consumer tastes, Mattel has to contend with retailers who stand between them and the end consumer. Massive retailers, such as Wal-Mart, can put price pressure on Mattel or demand special concessions. Mattel's three largest customers, Wal-Mart, Toys "R" Us, and Target, account for 35% of worldwide sales, and they have considerable buyer power. Mattel may also have to compete for retail space with private-

label toys from retailers. Mattel's nature as a global toy manufacturer with mass distribution means the company often has to deal with large retailers with considerable buyer power. Mattel has made some inroads towards managing this collective power by explicitly partnering with larger suppliers in initial advertising. Every mention of the new Tesla Hot Wheels products, for instance, reminds consumers that they are available at Toys “R” Us and Target.

Threat of New Entrants

Mattel is the second largest toy manufacturer, with its own powerful core brands and many globally recognized licenses. New entrants to the toy industry are unlikely to be able to compete at Mattel's level or seriously challenge the international nature of Mattel's business. However, Mattel does face threats from large-scale retailers potentially introducing their own private-label toys to compete with Mattel on price and with advantageous retail display. They also face vulnerability to the threat of direct product development and release by core license holders. To date, Walt Disney has preferred to rely on external licensing – and the power inherent in determining the holder of those licenses – rather than taking on manufacturing and other direct costs. However, in the emerging electronics development market, they are making some direct roads into core IP product development for existing digital platforms. Additionally, while Mattel's size and product diversity does render the company resistant to disruption by new toy makers, it is not invulnerable. The introduction of the Bratz doll line in 2001 by the much smaller MGA Entertainment had a serious impact on sales of Mattel's flagship Barbie line until Mattel successfully shut down the line in a legal dispute.

Threat of Substitutes

Substitution is a serious threat in the toy industry. Electronic games have been eroding toy sales in every age bracket, and this trend shows no signs of changing. The toy industry as a whole is having to adapt to slower growth and fiercer internal rivalry as a result of the encroachment of videogames. Mattel has tried to enter the video game industry in the past with Intellivision in 1979, and later through partnerships with Nintendo. Neither attempt to enter the electronic games industry went well for Mattel. Mattel is more vulnerable to substitution than its industry rival, Hasbro, mainly due to Hasbro having much better success at licensing its brands out to video game designers, notably the Transformers series. Sports are another possible substitute for Mattel's brands, as Mattel sold its sports subsidiary to Wham-O in 1997. Mattel has recently acquired a larger body of electronics-only character franchise, e.g. Call of Duty, along with their acquisition of MEGA Brands.

Financial Analysis

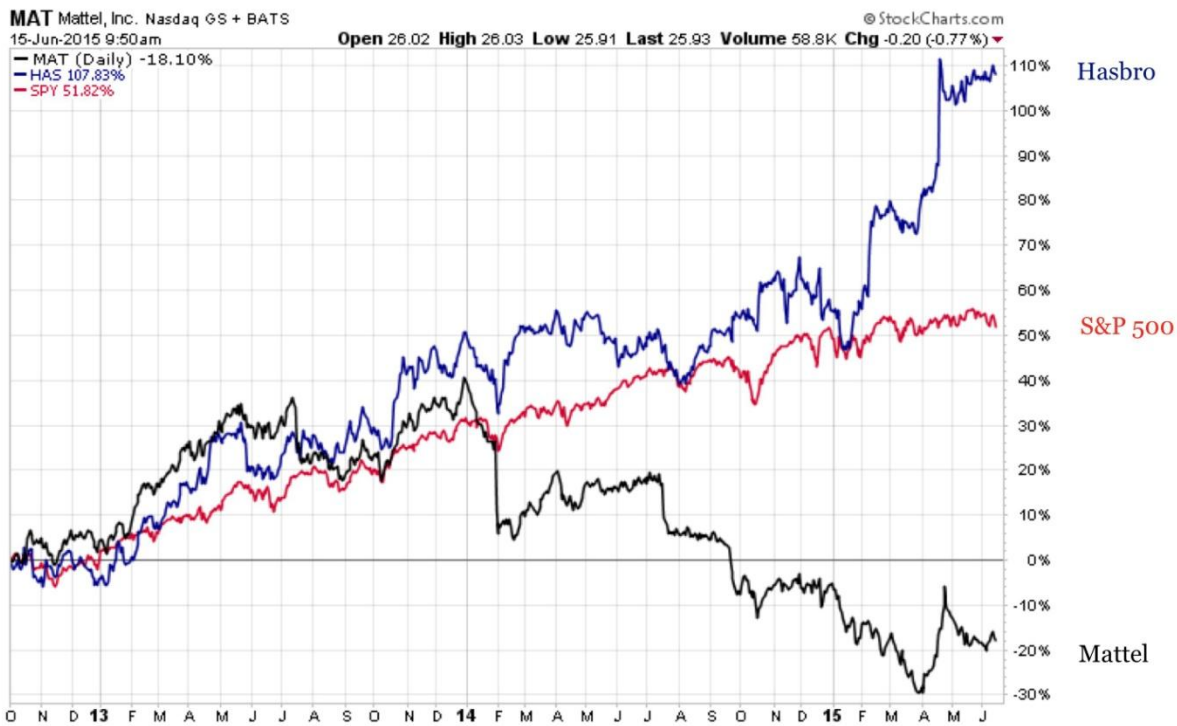
Despite a five-quarter sales slump, Mattel still has a strong financial position. It has a manageable debt load, reasonable (though declining) gross margin, and plentiful cash on hand. This relatively strong position is even more impressive considering the company spent \$423 million last year on acquiring MEGA Brands in order to gain entry into the construction toys market. Turbulence from integrating MEGA Brands accounts for significant portions of the increases in Selling, General and Administrative expenses. The strength of Mattel's corporate governance and the efficiency of its manufacturing cannot, however, make up for a seven percent

decline in net sales in 2014 against a background of an overall 4% growth in the toy industry. The essential problem at the heart of Mattel's woes is not financial, but in marketing.

Market Indicators

Mattel has a current market capitalization of \$9.02 billion, making it the second largest toy manufacturer in the world behind Lego. The stock value has been in decline since the end of 2013, where it was at a near five year high of \$44.10 per share. After missing 4th quarter earnings expectations, the stock price began falling and was at \$30.08 by 2014's end, as Mattel experienced nothing but bad news. The stock continued to plummet in 2015, and it hit a low of \$22.28 per share, barely half of its 2013 valuation. Recently, the stock has started to edge back up as Mattel has announced new Barbie lines and marketing initiatives. The fall in stock value can largely be attributed to Mattel's declining sales and the compounding effects of shrinking gross profits from net sales. Currently, Mattel trades at \$26.67 per share with a price to earnings ratio of 20.17. (See charts below).

Trouble Ahead, Opportunity Behind?

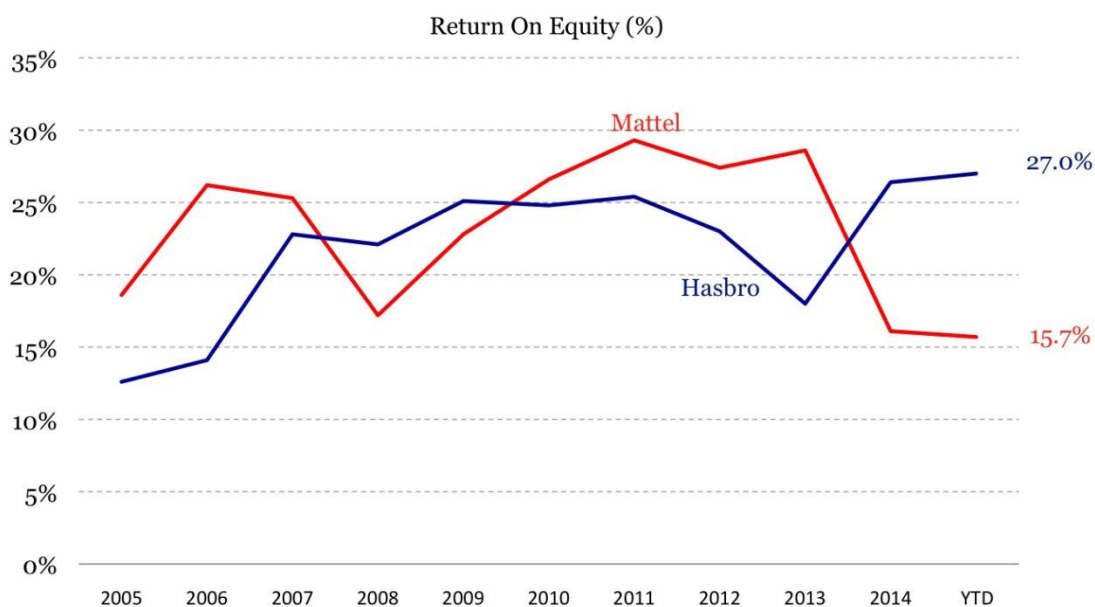


Source: Gerring Capital Partners, StockCharts.com

All three major credit rating agencies have either lowered Mattel's credit category or have given the company a negative future outlook on the basis of declining sales. Additionally, Mattel has received a strong sell recommendation throughout 2014, although recently it has been listed as a hold by a few research firms, such as Zack's¹⁰. In order to preserve stock value, Mattel has been repurchasing stocks and keeping its dividends unchanged despite the sales slump. Mattel repurchased \$177 million in stocks in 2014 and announced a \$.38 dividend for the 4th quarter of 2014 and another \$.38 dividend for the 1st quarter of 2015.

¹⁰ [The Legacy: Zach's Rates Mattel a "Hold"](#)

Hasbro Producing Better For Its Owners



Source: Gerring Wealth Management, Morningstar

<i>Solvency Measures</i>	<i>Mattel</i>	<i>Hasbro</i>
P/E	20.17 ¹¹	24.10 ¹²
EPS	.43 (vs. 1.06 in 2013) ¹³	1.32 (vs. .98 in 2013) ¹⁴
ROE	16.09% (vs. 28.61% in Q4 2013)	26.43% (vs. 17.95% in Q4 2013)

¹¹ [Gurufocus: Mattel P/E](#)

¹² [Gurufocus.com: Hasbro P/E](#)

¹³ [Nasdaq.com: Mattel EPS](#)

¹⁴ [Nasdaq.com: Hasbro EPS](#)

Liquidity and Solvency

Mattel operates in a highly seasonal industry, and it relies heavily on 4th quarter sales to finance the rest of the year. For the first three quarters of 2014 Mattel spent \$354 million more than it took in, not counting the \$423 million spent on acquiring MEGA Brands. However, Mattel keeps significant cash reserves to cushion spending throughout the year, and it still held \$262 million in reserves heading into the holiday season. Even with disappointing 4th quarter sales, Mattel ended FY2014 with \$972 million cash on hand, down slightly from \$1,039 million on hand at the end of 2013. This is still more than enough to continue Mattel's operations while also leaving cash on hand for strategic acquisitions.

Mattel holds \$2.1 billion in long-term debt, \$500 million of which was issued in 2014 as part of financing the acquisition of MEGA Brands. This gave the company an EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) ratio of 2.38 to 1 at the end of 2014 (currently 2.42:1 after 2015Q1). Under Mattel's lending agreements, it is allowed a maximum ratio of 3.00 to 1, meaning Mattel still has room to borrow if needed. By comparison, Mattel's nearest industry rival Hasbro has a current EBITDA ratio of 2.24:1, and the industry average is 3.17:1. Mattel's current debt to equity ratio is 0.79:1 compared to Hasbro's 1.23:1, likely reflecting Hasbro's aggressive borrowing to fund growth. Service on Mattel's long-term debt totaled 1% of net sales in 2014. (See charts below.)

<i>Solvency Measures (2014 Q4)</i>	<i>Mattel</i>	<i>Hasbro</i>
Net Income	\$149.9 million ¹⁵	\$169.9 million ¹⁶
Debt-to-Equity (D/E)	.71 ¹⁷	1.23 ¹⁸
EBITDA	\$238.6 million (vs. \$482.2 million in Q4 2013) ¹⁹	\$255.62 million (vs. \$179.1 million in Q4 2013) ²⁰
ROE	16.09% (vs. 28.61% in Q4 2013) ²¹	26.43% (vs. 17.95% in Q4 2013) ²²
DuPont: Asset Turnover	.92 (vs. 1.0 in Q4 2013)	.96 (vs. .94 in Q4 2013)
DuPont: Profit Margin	8.28% (vs. 13.94% in 2013)	9.72% (vs. 7.01%)
DuPont: Equity Multiplier	2.28 (vs. 1.98 in Q4 2013)	3.09 (vs. 2.62)

¹⁵ [Mattel Board Report Dec. 2014](#)

¹⁶ [Bloomberg: Hasbro Net Income Press Release](#)

¹⁷ [ycharts.com: Mattel](#)

¹⁸ [ycharts.com: Hasbro](#)

¹⁹ [Wikinvest: Mattel](#)

²⁰ [Wikinvest: Hasbro](#)

²¹ [Morningstar: Mattel](#)

²² [Morningstar: Hasbro](#)

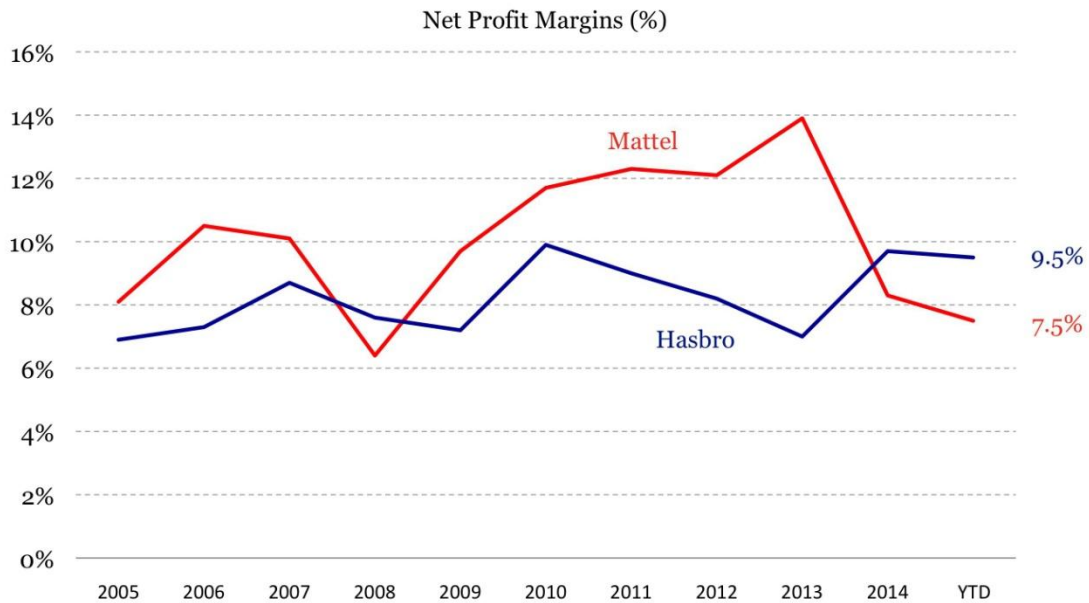
Profitability

The primary factor affecting Mattel's profitability is a decline in net sales. Sales dropped by 7% in 2014, despite overall growth of 4% in the toy industry. On top of the decline in net sales gross profits, net sales also declined by 380 basis points (53.6% to 49.8%) in 2014, leading to less take away from fewer sales. In its annual report, Mattel attributes two percentage points of the decrease in net sales to currency exchange rate volatility, with the remaining five points attributed to drops in sales of Barbie (down 16% from 2013), entertainment (a catch all term for non-core/Fisher-Price brands, down 20%) and Fisher-Price (down 13%).

The decrease in gross profits comes primarily from the impact of acquiring MEGA Brands. Though the costs are partially offset by operational savings realized through a corporate reorganization program called Operational Excellence 3.0, MEGA Brands-related costs also increased administrative expenditures. These expenses are unlikely to continue into 2015. Finally, advertising expenses for 2014 increased from 11.6% of net sales in 2013 to 12.2% of net sales. However, since overall net sales declined, Mattel actually spent less on advertising in absolute dollars in 2014, reflecting a failed strategy to concentrate advertising spending around the holiday season at the expense of the first two quarters.

The impact of both declining net sales and decreasing gross profits is that net income for 2014 was nearly cut in half from 2013, a drop of \$405 million from \$904 million in 2013 to \$499 million in 2014. This drop is what is driving Mattel's declining stock value, and it is what caused former CEO Bryan Stockton to be terminated. While the impact to gross profitability from MEGA Brands may be temporary, the ongoing decline in net sales is the real existential threat to the company.

Hasbro Vaults Over Mattel – Profit Margins



Source: Gerring Wealth Management, Morningstar

Strategic Recommendations

Move Beyond Being a Toy Company

The primary difference between declining Mattel and ascendant Hasbro is that Mattel still sees itself as a toy maker while Hasbro has embraced being a total brand experience. Beyond just manufacturing toys, Hasbro licenses its properties for major motion pictures, tie-in video games and branded clothing lines. Each aspect of this total experience is not only a revenue stream but an advertisement for each other aspect. Box office sales grow toy line sales, which contribute to clothing sales and boost video game sales. Hasbro approaches each brand as an opportunity across several industries, and while every license doesn't necessarily pay off (Battleship was a

box office disaster that left Hasbro holding millions in toy inventory) when it does the potential is enormous. The Transformers franchise has brought in \$3.7 billion in box office sales alone, and it launched several new Transformers toy lines, video games and branded clothing lines. Meanwhile, Mattel has quietly released 31 direct-to-DVD Barbie movies over the past 15 years, earning a mere \$100 million. While the DVDs no doubt help keep Barbie relevant to children, Mattel could be doing so much more with its flagship brand. Barbie needs a big box-office movie and a big-budget video game that aspires to more than the bargain bin offerings of Barbie Horse Adventures or Barbie: Groom and Glam Pups. Hot Wheels is also ripe for a coordinated multimedia campaign. Mattel should also consider bringing out an old brand and revitalizing it in much the same way Hasbro brought back My Little Pony and turned it into an enormously successful lifestyle product line. While Mattel's creation of an internal entertainment production company, Playground Productions, is a step in this direction, the company will need to seek outside expertise to successfully move beyond being a toy manufacturer to being an entertainment company.

Focus on Core Brands

Mattel has let the value of its core brands decay in favor of acquiring new brands and licenses. Instead of addressing declining sales in key product lines, the company has opted to try and diversify their business by purchasing MEGA Brands and getting into the construction toy industry. Mattel has a long track record of buying new product lines when their core brands experience difficulty, from the disastrous The Learning Company acquisition to the purchase of American Girls to offset declining Barbie sales. While many of these purchases have created value for the company, the number of brands has also made it difficult for Mattel to have a cohesive advertising and brand management strategy. Additionally, buying new brands instead

of addressing old brands means inevitably the new brands will fall to the same problems. American Girls is starting to experience the same decline in sales as Barbie. Mattel also relies heavily on licensed properties, which leaves the company vulnerable to the license holder. Mattel's investments in the Disney Princess line will benefit Hasbro instead when they take over the license next year. A strategy of focusing on core brands first leaves Mattel in a much stronger position and creates more opportunities for revenue streams by licensing strong internally held brands out to others. Licensing is important, because Mattel has made several attempts at moving into new industries in the past, mainly electronics, which have hugely failed. While the company should strive for total brand experiences, it should also recognize that, much as other companies license toy manufacturing to Mattel, Mattel should be licensing out Barbie movie production rights to movie companies like Disney.

Bring More Diversity

Mattel has issues with representation and diversity in many of its core product lines. The international brand recognition for Barbie, Hot Wheels and Mattel's other core products is not being used to its fullest potential. The company has missed opportunities to develop and structure their brands appropriately in different consumer markets with different key characteristics. For Barbie, this is particularly aggravated by the lack of mass-market appeal a total brand experience campaign of the sort Hasbro uses offers, as Barbie has neither local niche appeal by being manufactured, for example, with Latina features in Hispanic countries, nor the global appeal of having a definitive look and personality established by mass media. Barbie occupies the worst possible global marketing niche for a doll, completely generic but not representative of anywhere but America. These issues carry over to the domestic market, where Barbie's token efforts at diversity and her embrace of gender stereotypes has engrained Barbie as

a cultural joke. Missteps such as the infamous "Math class is tough!" talking Barbie and incompetent-computer-programmer Barbie have made the brand a punchline and contributed to its declining popularity, especially when up against empowering role models like the Disney Princesses. Mattel can and must do better. The company is taking the first steps by introducing more ethnically diverse Barbie dolls with a wider range of practical clothing, but Barbie needs a total rehabilitation. For brands like Hot Wheels, increasing diversity could mean introducing new cars that reflect the most common vehicles on the road in a given region. Fisher-Price products could especially benefit from being marketed more aggressively in regions of the world where video games and electronics pose less competition, getting around the problem of 'children getting older younger' that Mattel has identified in its current markets. Increasing diversity across product lines will improve sales and strengthen Mattel's core brands both domestically and internationally.